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CALIFORNIA

Single Audit Report

2003–04

Arnold Schwarzenegger, Governor
State of California

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DEPARTMENT OF
FINANCE
OFFICE OF THE DIRECTOR

ARNOLD SCHWARZENEGGER, GOVERNOR
STATE CAPITOL ■ ROOM 1145 ■ SACRAMENTO CA ■ 95814-4998 ■ WWW.DOF.CA.GOV

March 30, 2005

Mr. Daniel R. Levinson, Acting Inspector General
Department of Health and Human Services
Room 5250, Cohen Building
330 Independence Avenue, S.W
Washington, D.C 20201

Dear Mr. Levinson:

As the Governor's fiscal representative, I submit to you the State of California Single Audit Report for the fiscal year ended June 30, 2004. The report contains the Independent Auditor's Reports on the state's general-purpose financial statements; compliance and internal control over financial reporting; compliance and internal control related to federal grants; and schedule of federal assistance. Although the Independent Auditor identified reportable conditions related to internal control over financial reporting, the conditions were not considered material and do not adversely affect the state's general-purpose financial statements. The Independent Auditor also identified reportable conditions related to internal control over compliance with major federal program requirements. The instance of noncompliance specifically related to the Crime Victim Assistance program was considered material and resulted in a disclaimer of opinion for that particular program. All other instances of noncompliance were not considered material

California provides its citizens with numerous state and federal programs and activities, and is much more complex and vast than most economic entities in the world. Such complexity, along with ever-present budget constraints, challenges us to meet the requirements of those programs and activities efficiently and effectively. Moreover, such operations must exist within a system of internal and administrative control that safeguards assets and resources, and produces reliable financial information. Attaining these objectives and overseeing the financial and business practices of the state continues to be an important part of the Department of Finance's leadership.

The head of each state department is responsible for establishing and maintaining a system of internal accounting and administrative control within their department. Each state department with reportable internal control weaknesses or instances of noncompliance is responsible for developing and implementing corrective action plans. The Department of Finance will continue to provide leadership to ensure the proper financial operations and business practices of the state, and to ensure that internal controls exist for the safeguarding and effective use of assets and resources

If you have any questions concerning this letter, please contact Samuel E. Hull, Chief, Office of State Audits and Evaluations, at (916) 322-2985.

TOM CAMPBELL
Director
By:

(Original signed by Stephen W. Kessler)

STEPHEN W. KESSLER
Chief Deputy Director

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Overview of California's Economy in Fiscal Year 2003-04

Along with the nation, the California economy strengthened in 2004. Broad economic measures like personal income and taxable sales grew more quickly. Exports of made-in-California merchandise posted a good gain after plummeting for three years. Job growth resumed after two years of falling employment. Real estate markets made dramatic improvements.

Stronger Growth for California

Personal income received by California residents from all sources was up 5.4 percent from a year earlier in the first half of 2004. A year earlier, personal income was up only 2.4 percent. On this broad measure, the state did a little better than the nation, where personal income grew by 5.1 percent in the first half of 2004 and 2.3 percent in the first half of 2003.

Statewide taxable sales also grew more quickly in the first half of 2004, with sales 6.1 percent higher than in the first half of 2003. In the first half of 2003, they rose only 3.3 percent.

Made-in-California merchandise exports began to turn around in the fourth quarter of 2003 after falling by 26 percent in the preceding three years. In the first three quarters of 2004, exports were 20 percent higher than a year earlier. Increased exports to Mexico, mainland China, Japan, South Korea, France, Singapore, Hong Kong, Taiwan, and the United Kingdom were instrumental in the turnaround. Exports of computer and electronic products, transportation equipment, and machinery (except electrical) accounted for over three-quarters of the gain in total exports.

Like the nation, California enjoyed better job gains in 2004. California nonfarm payroll employment expanded 0.7 percent in 2004. In contrast, nonfarm payroll employment fell 0.4 percent in 2003. The improvement in 2004 was due primarily to better job growth in construction; trade, transportation, and utilities; and information and smaller declines in manufacturing employment. Limiting the improvement in job growth in 2004 were larger declines in government employment and smaller gains in the financial sector.

The San Francisco Bay Area passed a milestone in the second half of the year when it began to gain jobs for the first time in almost four years. The California recession during the early 2000s was concentrated in the Bay Area. While nonfarm payroll employment remains depressed, the region should contribute to state job growth going forward.

California housing markets continued to set new records in 2004, with sales up 3.8 percent and median prices up nearly 22 percent, according to the California Association of Realtors. Most of the sales gain was in the first half of the year when sales were up 7.4 percent. During the July-to-December period, sales were up only 0.5 percent compared to the same six-month period a year ago. Year-over-year, price gains have remained stable at the 18 to 23 percent level all year, although the pace was moderating somewhat at the end of the year.

Commercial real estate markets generally improved. Of the metropolitan areas surveyed by CB Richard Ellis, Orange, San Diego, and Ventura Counties were among the five counties in the nation with the lowest office vacancy rates in the third quarter of 2004. San Francisco, San Jose, and Oakland continued to have above-average vacancy rates, but San Francisco and San Jose vacancy rates declined appreciably over the last year. Industrial vacancy was well below the national average in Orange and Los Angeles Counties, but above the national average in San Francisco, San Diego, and Sacramento in the third quarter. Vacancy in the latter two jumped over the last year.

California's tourism and convention business continued to improve in 2004. Convention bookings were up in San Francisco, Anaheim, and San Diego, while lagging in Los Angeles. Non-convention related tourism was stronger in all four major markets. Hotel and motel occupancy rates improved in all major markets, and average daily room rates also increased. Passenger traffic was up at all major airports. Los Angeles International and San Francisco International experienced double digit-increases in both domestic and international travelers. Far East visitors returned in numbers, and business travel rebounded.

The state's economic fate is closely tied to the nation's. In the coming year, U.S. output growth is projected to slow somewhat, but wage and salary and personal income growth will pick up slightly. California will track the national economy on these measures.

Part One

State of California: Financial Report for the Year Ended June 30, 2004

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Required Supplementary Information

CALIFORNIA STATE AUDITOR

ELAINE M. HOWLE
STATE AUDITOR

STEVEN M. HENDRICKSON
CHIEF DEPUTY STATE AUDITOR

Independent Auditor's Report

THE GOVERNOR AND THE LEGISLATURE OF THE
STATE OF CALIFORNIA

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of California, as of and for the year ended June 30, 2004, which collectively comprise the State of California's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the State of California's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the following significant amounts in the financial statements of:

Government-wide Financial Statements

- Certain enterprise funds that, in the aggregate, represent 85 percent, 41 percent, and 50 percent, respectively, of the assets, net assets and revenues of the business-type activities.
- The University of California, State Compensation Insurance Fund, California Housing Finance Agency, and certain other funds that, in the aggregate, represent 76 percent, 89 percent, and 75 percent, respectively, of the assets, net assets and revenues of the discretely presented component units.

Fund Financial Statements

- The following major enterprise funds: Electric Power fund, Water Resources fund, Public Building Construction fund, and State Lottery fund.
- Certain nonmajor enterprise funds that represent 70 percent, 45 percent, and 81 percent, respectively, of the assets, net assets and revenues of the nonmajor enterprise funds.
- The funds of the Public Employees' Retirement System, State Teachers' Retirement System and the University of California Retirement System that, in the aggregate, represent 91 percent, 92 percent, and 70 percent, respectively, of the assets, net assets and additions of the fiduciary funds and similar component units.
- The discretely presented component units noted above.

Those financial statements were audited by other auditors whose reports have been furnished to us, and our opinions, insofar as it relates to the amounts included for those funds and entities, are based on the reports of the other auditors.

Except as discussed in the following paragraph, we conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the reports of other auditors provide a reasonable basis for our opinions.

The financial statements of the State Compensation Insurance Fund (SCIF) have not been audited, as discussed in Note 1, and we were not engaged to audit the SCIF financial statements as part of our audit of the State of California's basic financial statements. SCIF's financial activities are included in the State of California's basic financial statements as a discretely presented component unit and represent 24 percent, 9 percent, and 24 percent of the assets, net assets, and revenues, respectively, of the State of California's aggregate discretely presented component units.

In addition, as discussed in Note 1, management has not included the California Earthquake Authority (CEA) in the State of California's financial statements. Accounting principles generally accepted in the United States of America require the CEA to be presented as a discretely presented component unit and financial information about the CEA to be part of the aggregate discretely presented component units, thus increasing the component units' assets, liabilities, revenues, and expenses, and changing its net assets. The amount by which this departure would affect the assets, liabilities, net assets, revenues, and expenses of the State of California's aggregate discretely presented component units is not reasonably determinable.

In our opinion, because of the omission of the CEA, as discussed above, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of the CEA of the State of California as of June 30, 2004, or the changes in the financial position thereof for the year then ended.

In addition, in our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had SCIF's financial statements been audited, and the effects of not including financial information for the CEA as part of the aggregate discretely presented component units, as described above, the financial statements referred to above present fairly, in all material respects, the financial position of the aggregate discretely presented component units for the State of California, as of June 30, 2004, and the changes in financial position thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Further, in our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, each major fund, and the aggregate remaining fund information of the State of California, as of June 30, 2004, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, reports on the State's internal control structure and on its compliance with laws and regulations will be issued in our single audit report. These reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The management's discussion and analysis on pages 7 through 25, and schedule of funding progress, infrastructure information, budgetary comparison information, reconciliation of budgetary and GAAP-basis fund balances and related notes on pages 138 through 146 are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We and the other auditors have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the State of California's basic financial statements. The combining financial statements listed in the accompanying table of contents are presented for purposes of additional analysis and are not a required part of the basic financial statements. The combining financial statements have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, based on our audit and the reports of other auditors, are fairly stated in all material respects in relation to the basic financial statements taken as a whole. The introductory and statistical sections of this report have not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we express no opinion on them.

BUREAU OF STATE AUDITS

Philip Jelicich

PHILIP J. JELICICH, CPA
Deputy State Auditor

January 28, 2005

Management's Discussion and Analysis

The following Management's Discussion and Analysis is a required supplement to the State of California's financial statements. It describes and analyzes the financial position of the State, providing an overview of the State's activities for the year ended June 30, 2004. We encourage readers to consider the information presented here in conjunction with information that is provided in our letter of transmittal at the front of this report and in the State's financial statements and notes, which follow this section.

Financial Highlights – Primary Government

Government-wide Highlights

California's economy is improving and its policymakers are taking action to reduce spending and augment revenues to address the budgetary imbalances that have plagued the State since the 2001-02 fiscal year. The State experienced moderate increases in general revenues, primarily personal income, corporate, and sales tax revenues, while expenses remained stable. However, the expenses for the State's governmental activities have again exceeded its revenues. Revenues for the State's business-type activities approximated its expenses for all categories except unemployment programs, which had expenses that were $640 million in excess of revenues. As a result, net assets for both governmental and business-type activities decreased during the 2003-04 fiscal year, but the decline of 18% was much less than the 416% decrease last year.

Net Assets — The primary government had net assets of $40.0 billion as of June 30, 2004. After reducing this total amount by $78.8 billion for investment in capital assets (net of related debt) and by $12.8 billion for restricted net assets, the resulting unrestricted net assets were a negative $51.6 billion. Restricted net assets are dedicated for specified uses and are not available to fund current activities. More than half of the negative $51.6 billion is a result of the $28.2 billion in outstanding bonded debt issued to build capital assets for school districts and other local governmental entities. The bonded debt reduces the unrestricted net assets, but the capital assets that would offset the reduction are recorded by local government instead of the State.

Changes in Net Assets — The primary government's total net assets decreased by $8.5 billion (a 17.5% decrease) during the year ended June 30, 2004. Net assets of governmental activities decreased by $7.5 billion (18.9%), while net assets of business-type activities decreased by $1.0 billion (11.2%).

Fund Highlights

Governmental Funds — As of June 30, 2004, the primary government's governmental funds reported a combined ending fund balance of $11.5 billion, an increase of $13.5 billion from the previous fiscal year. After reducing this total fund balance amount by $16.3 billion in reserves, the unreserved fund balance totaled a negative $4.8 billion.

Proprietary Funds — As of June 30, 2004, the primary government's proprietary funds reported combined ending net assets of $8.7 billion, a decrease of $1.0 billion from the previous fiscal year. After reducing the total net assets by $1.5 billion for investment in capital assets (net of related debt) and expendable restrictions of $5.7 billion, the unrestricted net assets totaled $1.5 billion.

Noncurrent Assets and Liabilities

As of June 30, 2004, the primary government‘s noncurrent assets totaled $116.4 billion, of which $91.3 billion was related to capital assets. The capital assets include the retroactive reporting of $63.9 billion for the historical cost of state highway infrastructure and related land.

The primary government‘s noncurrent liabilities totaled $90.2 billion, which consisted of $44.6 billion of general obligation bonds, $29.4 billion of revenue bonds, and $16.2 billion in other noncurrent liabilities.

Overview of the Financial Statements

This discussion and analysis is an introduction to the State's basic financial statements, which include four components: (1) government-wide financial statements, (2) fund financial statements, (3) discretely presented component units financial statements, and (4) notes to the financial statements. This report also contains required supplementary information and combining financial statements and schedules.

Government-wide Financial Statements

Government-wide financial statements are designed to provide readers with a broad overview of the State's finances. The government-wide financial statements do not include programs and activities of the primary government and component units that are fiduciary in nature, because their resources are not available to support state programs. The statements provide both short-term and long-term information about the State's financial position, which assists the reader in assessing the State’s economic condition at the end of the fiscal year. These statements are prepared using the economic resources measurement focus and the accrual basis of accounting. This means they follow methods that are similar to those used by most businesses. They take into account all revenues and expenses connected with the fiscal year, regardless of when the cash involved was received or paid. The government-wide financial statements include two statements: the Statement of Net Assets and the Statement of Activities.

- The *Statement of Net Assets* presents all of the State's assets and liabilities, with the difference between the two reported as net assets. Over time, increases or decreases in net assets are expected to serve as a useful indicator of whether the financial position of the State is improving or deteriorating.

- The *Statement of Activities* presents information showing how the State's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of the related cash flows. Thus, revenues and expenses are reported in this statement for some items that will result in cash flows in future fiscal periods (e.g., uncollected taxes and earned but unused vacation leave). This statement also presents a comparison between direct expenses and program revenues for each function of the State.

The government-wide financial statements have separate columns for three different types of state programs or activities: governmental activities, business-type activities, and component units.

- *Governmental activities* are mostly supported by taxes, such as personal income and sales and use taxes, and intergovernmental revenues, primarily federal grants. Most services and expenses normally associated with state government fall into this activity category, including health and human services, education (public kindergarten through 12th grade (K-12) schools and higher education), business and transportation, correctional programs, general government, resources, tax relief, state and consumer services, and interest on long-term debt.

- *Business-type activities* are normally intended to recover all or a significant portion of their costs through user fees and charges to external users of goods and services. The business-type activities of the State of California include providing unemployment insurance programs, providing housing loans to California veterans, providing water to local water districts, providing building aid to school districts, operating toll collection facilities, providing services to California State University students, leasing public assets, selling California State Lottery tickets, and selling electric power. These activities are carried out with minimal financial assistance from the governmental activities of the State.

- *Component units* are organizations that are legally separate from the State, but the State is either financially accountable for them, or the nature and significance of their relationship with the State is such that their exclusion would cause the State's financial statements to be misleading or incomplete. The State of California has blended, fiduciary, and discretely presented component units.

  - *Blended component units*, although legally separate entities, are in substance part of the primary government's operations. Therefore, data from blended component units are integrated into the appropriate funds for reporting purposes. The Golden State Tobacco Securitization Corporation and certain building authorities that are blended component units of the State have been included in the governmental activities.

  - *Fiduciary component units* are legally separate from the primary government but, due to their fiduciary nature, are included with the primary government's fiduciary funds. The Public Employees' Retirement System, the State Teachers' Retirement System, and the University of California Retirement System are fiduciary component units and have been included with the State's pension and other employee benefit trust funds, which are not included in the government-wide financial statements.

  - *Discretely presented component units* are legally separate from the primary government and provide services to entities and individuals outside the primary government. Activity of discretely presented component units is presented in a single column in the government-wide financial statements.

Information on how to obtain financial statements of the individual component units is available from the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, CA 94250.

Fund Financial Statements

Fund financial statements are provided for governmental funds, proprietary funds, fiduciary funds and similar component units, and discretely presented component units. A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The State of California, like other state and local governments, uses fund accounting to ensure and demonstrate compliance with finance-related legal and contractual requirements. Following are general descriptions of the three types of funds.

- *Governmental funds* are used to account for essentially the same functions that are reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the end of the fiscal year. Such information may be useful in evaluating a government's near-term financing requirements. This approach is known as using the flow of current financial resources measurement focus and the modified accrual basis of accounting. These statements provide a detailed short-term view of the State's finances that assists in determining whether there will be adequate financial resources available to meet the current needs of the State.

Because the focus of governmental fund financial statements is narrower than that of government-wide financial statements, it is useful to compare these statements with the governmental activities information presented in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund Balance Sheet and the governmental fund Statement of Revenues, Expenditures, and Changes in Fund Balances provide a reconciliation, to facilitate a comparison between governmental funds and governmental activities in the government-wide statements. These reconciliations are presented on the page immediately following the governmental fund financial statements. Primary differences between the government-wide and fund statements relate to noncurrent assets, such as land and buildings, and noncurrent liabilities, such as bonded debt and amounts owed for compensated absences and capital lease obligations, which are reported in the government-wide statements but not in the fund-based statements.

- *Proprietary funds* are used to show activities that operate more like those found in the private sector. The State of California has two proprietary fund types: enterprise funds and internal service funds.

    - *Enterprise funds* record activity for which a fee is charged to external users; they are presented as business-type activities in the government-wide financial statements.

    - *Internal service funds* are used to accumulate and allocate costs internally among the State of California's various functions. For example, internal service funds provide information technology, printing, fleet management, and architectural services primarily for state departments. As a result, their activity is considered governmental.

- *Fiduciary funds* are used to account for resources held for the benefit of parties outside the State. Fiduciary funds and the activities of fiduciary component units are not reflected in the government-wide financial statements, because the resources of these funds are not available to support State of California programs. The accounting used for fiduciary funds and similar component units is much like that used for proprietary funds.

Discretely Presented Component Units Financial Statements

As discussed previously, the State has financial accountability for discretely presented component units, which have certain independent qualities and operate similarly to private-sector businesses. The activity of the discretely presented component units is classified as enterprise activity.

Notes to the Financial Statements

The notes to the financial statements provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements, which discuss particular accounts in more detail, can be found immediately following the discretely presented component units financial statements.

Required Supplementary Information

A section of required supplementary information follows the notes to the basic financial statements. This section includes a schedule of funding progress for certain pension trust funds, information on infrastructure assets using the modified approach, a budgetary comparison schedule, and a separate reconciliation between the statutory fund balance for budgetary purposes and the fund balance for the major governmental funds presented in the governmental fund financial statements.

Combining Financial Statements and Schedules

The next section contains *combining statements* that provide separate financial statements for nonmajor governmental funds, proprietary funds, fiduciary funds, and nonmajor component units. Information for these entities is presented only in summary form in the basic financial statements.

Government-wide Financial Analysis

Net Assets

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. The primary government's combined net assets (governmental and business-type activities) declined 17.5%, from $48.5 billion, as restated, at June 30, 2003, to $40.0 billion a year later. The prior-year net assets were restated to include $63.9 billion of retroactively reported state highway infrastructure assets.

A large segment of the primary government's net assets is its $78.8 billion investment in capital assets, such as land, building, equipment, and infrastructure (roads, bridges, and other immovable assets), less any related debt used to acquire those assets that is still outstanding. The State uses capital assets to provide services to citizens; consequently, these assets are not available for future spending. Although the State's investment in capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, because the capital assets themselves cannot be used to liquidate the liabilities.

Another $12.8 billion of the primary government's net assets represents resources that are subject to external restrictions on how they may be used, such as resources pledged to debt service. Internally imposed designations of resources are not presented as restricted net assets. The balance of unrestricted net assets of governmental activities (if positive) may be used to meet the State's ongoing obligations to citizens and creditors. As of June 30, 2004, governmental activities showed an unrestricted net assets deficit of $52.9 billion and business-type activities showed unrestricted net assets of $1.3 billion.

A large portion of the negative unrestricted net assets of governmental activities is a result of the $28.2 billion in outstanding bonded debt issued to build capital assets for school districts and other local governmental entities. Because the State does not own these capital assets, neither the assets nor the bonded debt is included in the portion of net assets reported as "investment in capital assets, net of related debt." Instead, the bonded debt reduces the State's unrestricted net assets. A deficit in unrestricted net assets of governmental activities can be expected to continue as long as the State has significant obligations outstanding for school districts and other local governmental entities.

Table 1 presents condensed financial information derived from the Statement of Net Assets for the primary government.

Table 1

Net Assets – Primary Government
June 30, 2004
(amounts in millions)

	Governmental Activities		Business-type Activities		Total	
	2004	**2003***	**2004**	**2003***	**2004**	**2003***
ASSETS						
Current and other assets	$ 37,149	$ 35,005	$ 31,037	$ 34,188	$ 68,186	$ 69,193
Capital assets	85,248	19,321	6,070	5,374	91,318	24,695
Total assets	**122,397**	**54,326**	**37,107**	**39,562**	**159,504**	**93,888**
LIABILITIES						
Noncurrent liabilities	64,333	41,657	25,912	27,030	90,245	68,687
Other liabilities	26,101	37,186	3,153	3,327	29,254	40,513
Total liabilities	**90,434**	**78,843**	**29,065**	**30,357**	**119,499**	**109,200**
NET ASSETS						
Investment in capital assets net of related debt	77,734	14,180	1,058	1,405	78,792	15,585
Restricted	7,126	5,231	5,667	7,926	12,793	13,157
Unrestricted	(52,897)	(43,928)	1,317	(126)	(51,580)	(44,054)
Total net assets	**$ 31,963**	**$ (24,517)**	**$ 8,042**	**$ 9,205**	**$ 40,005**	**$ (15,312)**

*Not restated

Changes in Net Assets

The expenses of the primary government totaled $164.1 billion for the year ended June 30, 2004. Of this amount, $74.8 billion (45.6%) was funded with program revenues (charges for services or program-specific grants and contributions), leaving $89.3 billion to be funded with general revenues (mainly taxes). However, the primary government's general revenues and transfers totaled only $80.9 billion, so total net assets decreased by $8.5 billion, or 17.5%, during the year.

Of the total decrease, net assets for governmental activities decreased by $7.5 billion, while those of business-type activities decreased by $1.0 billion. The decrease in governmental activities was caused by a continued structural budget shortfall that results in the State's expenses exceeding its revenues. The decrease in business-type activities was mainly caused by unemployment benefit payments exceeding employer contributions and other revenue for unemployment programs.

Table 2 presents condensed financial information derived from the Statement of Activities for the primary government.

Table 2

Changes in Net Assets – Primary Government
Year ended June 30, 2004
(amounts in millions)

	Governmental Activities		Business-type Activities		Total	
	2004	**2003**	**2004**	**2003**	**2004**	**2003**
REVENUES						
Program revenues:						
Charges for services	$ 13,121	$ 13,131	$ 19,595	$ 19,937	$ 32,716	$ 33,068
Operating grants and contributions	41,072	38,409	—	1	41,072	38,410
Capital grants and contributions	917	1,302	48	145	965	1,447
General revenues:						
Taxes	80,056	70,733	—	—	80,056	70,733
Investment and interest	155	372	—	—	155	372
Miscellaneous	687	582	—	—	687	582
Total revenues	**136,008**	**124,529**	**19,643**	**20,083**	**155,651**	**144,612**
EXPENDITURES						
Program expenses:						
General government	8,011	8,601	—	—	8,011	8,601
Education	51,458	51,447	—	—	51,458	51,447
Health and human services	60,021	59,141	—	—	60,021	59,141
Resources	4,436	3,431	—	—	4,436	3,431
State and consumer services	1,029	437	—	—	1,029	437
Business and transportation	7,579	7,515	—	—	7,579	7,515
Correctional programs	6,215	6,681	—	—	6,215	6,681
Tax relief	3,007	3,921	—	—	3,007	3,921
Interest on long-term debt	1,738	1,781	—	—	1,738	1,781
Electric Power	—	—	5,203	4,985	5,203	4,985
Water Resources	—	—	731	740	731	740
Public Building Construction	—	—	297	348	297	348
State Lottery	—	—	3,348	2,791	3,348	2,791
Unemployment Programs	—	—	10,272	10,652	10,272	10,652
Nonmajor enterprise	—	—	770	2,300	770	2,300
Total expenses	**143,494**	**142,955**	**20,621**	**21,816**	**164,115**	**164,771**
Deficiency before transfers	**(7,486)**	**(18,426)**	**(978)**	**(1,733)**	**(8,464)**	**(20,159)**
Transfers	33	67	(33)	(67)	—	—
Change in net assets	(7,453)	(18,359)	(1,011)	(1,800)	(8,464)	(20,159)
Net assets, beginning of year (restated)	**39,416**	**(6,158)**	**9,053**	**11,005**	**48,469**	**4,847**
Net assets, end of year	**$ 31,963**	**$ (24,517)**	**$ 8,042**	**$ 9,205**	**$ 40,005**	**$ (15,312)**

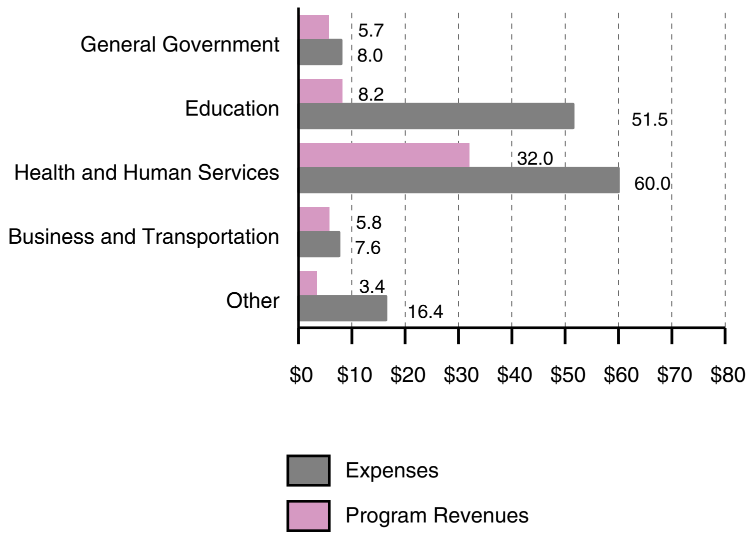
Governmental Activities

The expenses of governmental activities totaled $143.5 billion. Only $55.1 billion (38.4%) was funded with program revenues, of which $42.0 billion was federal grant money, leaving $88.4 billion to be funded with general revenues (mainly taxes). However, general revenues and transfers for governmental activities totaled only $80.9 billion, so governmental activities' total net assets decreased by $7.5 billion, or 18.9%, during the year ended June 30, 2004. The State issued $10.9 billion of Economic Recovery Bonds to help meet its cash flow needs.

Chart 1 presents a comparison of governmental activities expenses by program, with related revenues.

Chart 1

Expenses and Program Revenues – Governmental Activities
Year Ended June 30, 2004
(amounts in billions)



For the year ended June 30, 2004, total state tax revenues collected for governmental activities increased over the last year. The largest increase in state tax revenue occurred in personal income taxes, due to the recovery of the stock market and capital gains from the strong real estate market.

Overall expenses for governmental activities were relatively unchanged, with only a $538 million (0.4%) increase. However, the expenses for some activities increased, while the expenses for other activities decreased. The largest increases in expenses were a $1.0 billion increase in resources spending and a $879 million increase in health and human services spending. The increased resources spending was mainly attributable to amounts owed to flood victims for recently settled court cases. The increase in health and human services spending was the result of increased medical and social services caseloads. The largest decrease in expenses was a $914 million decrease in tax relief in the General Fund. The General Fund is discussed in more detail in the Fund Financial Analysis section under Governmental Funds.

Charts 2 and 3 present the percentage of total expenses for each program of governmental activities and the percentage of total revenues by source.

Chart 2

Expenses – Governmental Activities
Year ended June 30, 2004
(as a percent)

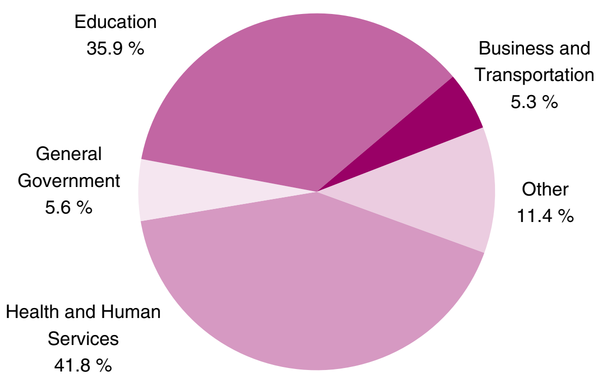
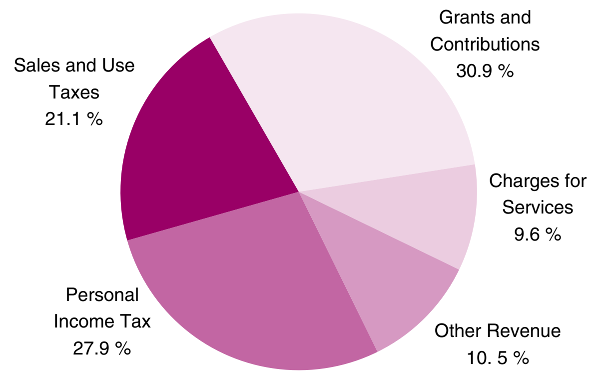


Chart 3

Revenues by Source – Governmental Activities
Year ended June 30, 2004
(as a percent)



Business-type Activities

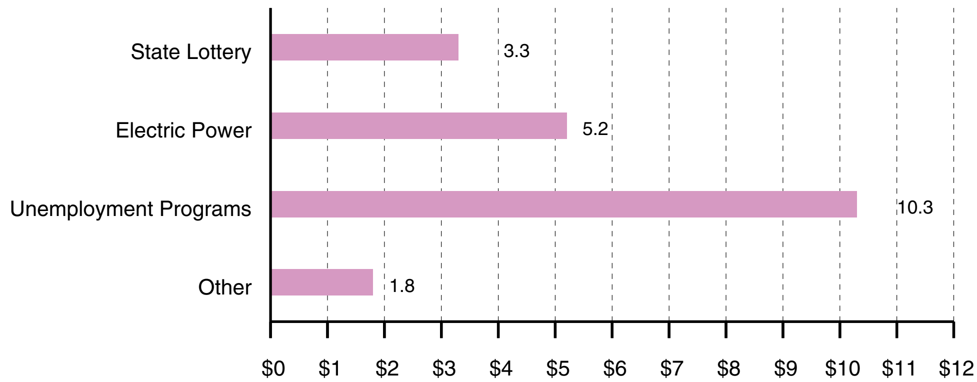
The expenses of business-type activities totaled $20.6 billion, with $19.6 billion, or 95.1%, paid by program revenues, such as fees, penalties, and charges for services. Business-type activities' total net assets decreased by $1.0 billion, or 11.2%, during the year ended June 30, 2004.

Most of the decrease in net assets was the result of a $626 million reduction in unemployment programs' net assets, discussed in more detail in the Fund Financial Analysis section under Proprietary Funds. As a result of the economic downturn in 2001 and 2002 and increases in benefits, payments of unemployment and unemployment disability claims continued to exceed insurance receipts for the fiscal year.

Chart 4 presents a comparison of the expenses of the State‘s business-type activities.

Chart 4

Expenses – Business-type Activities
Year ended June 30, 2004
(amounts in billions)



Fund Financial Analysis

The financial position of the State's governmental funds improved significantly during the year. Governmental funds rely heavily on taxes to support the majority of the State's services and programs. Personal income, corporate, and sales taxes increased during the year, resulting in a positive fund balance, in contrast to the previous year's fund deficit. On the other hand, all but one of the major proprietary funds, the Unemployment Programs Fund, had revenues that were not substantially different from expenses during the year ended June 30, 2004.

Governmental Funds

The Balance Sheet of the governmental funds reported $41.5 billion in assets, $30.0 billion in liabilities, and $11.5 billion in fund balance as of June 30, 2004. The largest change in account balance was a decrease in contracts and notes payable of $11.0 billion, which was related to the repayment of revenue anticipation warrants. Within the total fund balance, $16.3 billion has been set aside in reserve. The reserved amounts are not available for new spending, because they have been committed for outstanding contracts and purchase orders ($6.6 billion), noncurrent interfund receivables and loans receivable ($4.7 billion), and continuing appropriations ($5.0 billion). The balance of the governmental funds that is unreserved is a negative $4.8 billion.

The Statement of Revenues, Expenditures, and Changes in Fund Balances of the governmental funds shows $135.3 billion in revenues, $144.7 billion in expenditures, and a net $22.9 billion in receipts from other financing sources (uses). The ending fund balance of the governmental funds for the year ended June 30, 2004, was $11.5 billion, which was a $13.5 billion increase over the previous year's restated ending fund balance of a negative $2.0 billion. The increase in the combined fund balance of the governmental funds was a result of an increase in state tax revenues and the sale of $10.9 billion of Economic Recovery Bonds. Personal income taxes, which account for 47.6% of tax revenues and 27.9% of total governmental fund revenues, increased by $5.1 billion from the previous fiscal year. The increase in state tax revenues is attributable to the growth in the economy, fueled by the recovery of the stock market, capital gains from the booming real estate market, and strength in consumer spending.

The State's major governmental funds are the General Fund, the Federal Fund, and the Transportation Construction Fund. The General Fund ended the fiscal year with a negative fund balance of $1.5 billion. The Federal Fund and the Transportation Construction Fund ended the fiscal year with fund balances of $56 million and $3.6 billion, respectively. The nonmajor governmental funds ended the year with a total fund balance of $9.4 billion.

General Fund: As shown on the Balance Sheet, the General Fund (the State's main operating fund) ended the fiscal year with assets of $12.8 billion, liabilities of $14.3 billion, and fund balance reserves of $1.7 billion. This left the General Fund with an unreserved fund deficit of $3.2 billion. The asset with the largest account balance change is receivables, which increased from $6.0 billion to $7.5 billion. The increase is primarily due to a change in the method used to accrue tax payments from both corporation and personal income taxes. The change resulted in an accrual of $1.3 billion more than would have been accrued under the previous method. The liabilities with the largest account balance change are due to other funds, due to other governments, and contracts and notes payables. Due to other funds increased from $1.6 billion to $3.4 billion, and due to other governments decreased from $4.7 billion to $2.7 billion. The change in these accounts is primarily due to the deferral of school apportionment payments in the amount of $1.4 billion, which was reclassified from due to other governments to due to the State School Fund (an agency fund). The decrease in contracts and notes payables is attributed to the repayment of revenue anticipation warrants of $11.0 billion.

As shown on the Statement of Revenues, Expenditures, and Changes in Fund Balances of the governmental funds, the General Fund had $74.7 billion in revenues, $73.7 billion in expenditures, and a net $10.8 billion in receipts from other financing sources (uses) for the year ended June 30, 2004. The largest source of General Fund revenue was $72.9 billion in taxes, primarily personal income taxes ($37.7 billion) and sales and use taxes ($23.8 billion). The taxes with the largest increase in revenues were personal income taxes, which increased by $5.1 billion, to $37.7 billion, and corporation income taxes, which increased by $1.5 billion, to $8.4 billion. In addition to the growth in the economy, these increases were also related to stronger-than-expected revenues from an amnesty program relating to abusive tax shelters, and a change in the method used to accrue tax revenues. Sales and use taxes increased by $1.4 billion, to $23.8 billion, which is attributable to strong consumer spending. Escheat revenue, a new revenue source of the General Fund, was reported in the fiduciary funds in prior years. The escheat revenues of $599 million are now reported in the fund in which the property ultimately escheats.

General Fund expenditures decreased by $2.9 billion, to $73.7 billion. The programs with the largest decreases were education, which decreased by $1.3 billion, to $36.3 billion, and tax relief, which decreased by $914 million, to $3.0 billion. The decrease in education expenditures was a result of an across-the-board reduction for K-12 schools and community colleges, and a base-funding reduction for higher education. The decrease in tax relief results from the deferral of vehicle license fee (VLF) offset payments to local governments caused by suspension and subsequent reinstatement of the VLF offset program. The General Fund's ending fund balance (including reserves) for the year ended June 30, 2004, was a deficit of $1.5 billion, which is an increase of $11.8 billion from the previous year's ending fund deficit of $13.4 billion.

The amount transferred to the General Fund increased by $10.3 billion, to $14.0 billion. This increase was primarily a result of the transfer of Economic Recovery Bond proceeds from the Economic Recovery Fund, a nonmajor governmental fund. A similar increase occurred in the amount transferred out of the nonmajor governmental funds.

Federal Fund: This fund reports federal grant revenues and the related expenditures to support the grant programs. By far the largest of these program areas is health and human services, which accounted for $29.5 billion (72.7%) of the total $40.6 billion in fund expenditures. The Medical Assistance Program and the Temporary Assistance for Needy Families program are included in this program area. Education programs also constituted a large part of the fund's expenditures—$6.1 billion (15.1%)—most of which were apportionments made to local educational agencies. Total revenues and expenditures increased by approximately $785 million and $2.0 billion, respectively, over prior-year fund activity. The main reason for these increases is a shift in medical assistance program and correctional program expenditures from the General Fund to the Federal Fund as a result of the receipt of additional federal funds for these programs. The Federal Fund had a fund balance decrease of $551 million, to $56 million.

Transportation Construction Fund: This fund accounts for gasoline taxes, bond proceeds, and other revenues used for highway and passenger rail construction. Both revenues and expenditures increased slightly—7% and 1%, respectively—compared to prior-year activity. Fund expenditures of $3.6 billion exceeded revenues of $3.3 billion by approximately $247 million. However, the fund balance increased by $1.5 billion, due to the first-time issuance of $1.2 billion in Bay Area Toll Bridges Seismic Retrofit Bonds and $615 million in Federal Highway Grant Anticipation Revenue Vehicles (GARVEE bonds).

Proprietary Funds

Enterprise Funds: In general, the solid growth of the economy did not have as significant an effect on enterprise funds as it did on governmental funds. Most major enterprise funds' activity remained stable, with revenues approximating expenses. The exception was the Unemployment Programs Fund, which had expenses that exceeded revenues and transfers by $626 million.

As shown on the Statement of Net Assets of the proprietary funds, total assets of the enterprise funds were $37.6 billion as of June 30, 2004. Of this amount, current assets totaled $9.1 billion and noncurrent assets totaled $28.5 billion. The largest changes in asset account balances were a decrease of $1.4 billion in the amount on deposit with the U.S. Treasury for unemployment programs, because payments of unemployment and unemployment disability claims exceeded the insurance receipts for the fiscal year, and a decrease of $1.0 billion in investments due to the reclassification of the Public Employees' Benefits Fund from an enterprise fund to a discretely presented component unit. The total liabliities of the enterprise funds were $29.6 billion. The largest liability accounts were revenue bonds payable of $21.3 billion and general obligation bonds payable of $2.0 billion. The largest changes in the liability account balances were an $898 million decrease in benefits payable caused by the previously mentioned reclassification of the Public Employees' Benefits Fund, and a $640 million net decrease in general obligation bonds payable resulting from the retirement of general obligation bonds and the issuance of veteran home-purchase revenue bonds to refund general obligation bonds.

Total net assets of the enterprise funds were $8.0 billion as of June 30, 2004. Total net assets consisted of three segments: expendable restricted net assets of $5.7 billion; investment in capital assets (net of related debt) of $1.0 billion; and unrestricted net assets of $1.3 billion. The fund with the largest net assets was the Unemployment Programs Fund, with $2.5 billion (31.3% of the enterprise funds' total net assets).

As shown on the Statement of Revenues, Expenses, and Changes in Fund Net Assets of the proprietary funds, the enterprise funds ended the year with operating revenues of $18.4 billion, operating expenses of $18.1 billion, and net disbursements from other transactions of $1.4 billion. The largest sources of operating revenue were unemployment and disability insurance receipts of $8.6 billion in the Unemployment Programs Fund, and power sales of $4.3 billion collected by the Electric Power Fund. The largest operating expenses were distributions to beneficiaries of $10.0 billion by the Unemployment Programs Fund and power purchases (net of recoverable costs) of $4.2 billion by the Electric Power Fund. The ending net assets of the enterprise funds for the year ended June 30, 2004, were $8.0 billion, or $1.0 billion less than the previous year's ending fund balance of $9.0 billion, as restated. The main reasons for the decrease were a $626 million loss from the Unemployment Programs Fund, a $204 million loss from the State Lottery Fund, and the reclassification of the Public Employees Benefits Fund. Although expenditures of the Unemployment Programs Fund exceeded its revenues again this year, the resulting 19.9% decrease in net assets was much less than last year's 43.4% decrease, because it was offset by higher revenues from increased unemployment insurance and disability contribution rates.

Internal Service Funds: Total net assets of the internal service funds were $614 million as of June 30, 2004. These net assets consist of two segments: investment in capital assets (net of related debt) of $460 million and unrestricted net assets of $154 million.

Fiduciary Funds

The State of California has four types of fiduciary funds: private purpose trust funds, pension and other employee benefit trust funds, investment trust funds, and agency funds. The private purpose trust funds ended the fiscal year with net assets of $1.4 billion. The pension and other employee benefit trust funds ended the fiscal year with net assets of $339 billion. The State's only investment trust fund, the Local Agency Investment Fund, ended the fiscal year with net assets of $21.9 billion. Agency funds act as clearing accounts and thus do not have net assets.

For the year ended June 30, 2004, the fiduciary funds' combined net assets were $363 billion, a $45.0 billion increase from the prior year. The main reason for the increase in net assets was an increase in the fair value of investments of retirement funds.

The Economy for the Year Ending June 30, 2004

Employment in California reached a low point in the second quarter of 2003 and experienced slow, uneven growth through the first two quarters of the 2003-04 fiscal year. Job growth picked up in early 2004, only to slow again in the spring of 2004. The weakness in the California economy continued to be concentrated in the high technology industries of the Bay Area. By the spring of 2004, employment in the information technology industry had fallen by 22% since its peak in the final quarter of 2000. Across the State, employment in government at all levels—federal, state, and local—also lagged.

On the positive side, jobs were added in construction, professional and business services, financial services, and health and education services during the year. Recovery of the stock market in 2003 and early 2004, as well as robust consumer spending and capital gains from a strong real estate market, contributed to strong gains in personal income and corporation tax revenues.

General Fund Highlights

The original General Fund budget of $79.8 billion was reduced by $597 million, mainly for medical assistance program expenditures that were funded with additional federal revenue received during the year. During the 2003-04 fiscal year, General Fund actual expenditures were $78.5 billion, $739 million less than the final budgeted amounts. Decreased General Fund spending, coupled with the proceeds of $2.6 billion from Golden State Tobacco Securitization Corporation bonds and $10.9 billion from Economic Recovery Bonds, resulted in an improved General Fund balance, from a negative $13.4 billion at June 30, 2003, to a negative $1.5 billion a year later, an increase of 88.8%. This improvement was primarily attributable to increased tax revenues, external borrowing, and reduced spending by the General Fund.

Table 3

General Fund Original and Final Budgets
Year ended June 30, 2004
(amounts in millions)

	Original	Final	Increase/ (Decrease)
Budgeted amounts			
State and consumer services	$ 448	$ 472	$ 24
Business and transportation	314	315	1
Resources	716	865	149
Health and human services	24,126	23,186	(940)
Correctional programs	5,526	5,298	(228)
Education	36,981	37,159	178
General government:			
Tax relief	4,037	4,049	12
Debt service	2,127	2,131	4
Other general government	5,520	5,723	203
Total	**$ 79,795**	**$ 79,198**	**$ (597)**

Capital Assets and Debt Administration

Capital Assets

The State's investment in capital assets for its governmental and business-type activities as of June 30, 2004, amounted to $91.3 billion (net of accumulated depreciation). This investment in capital assets includes land, state highway infrastructure, collections, buildings and other depreciable property, and construction in progress. Depreciable property includes buildings, improvements other than buildings, equipment, personal property, intangible assets, certain infrastructure assets, certain books, and other capitalized and depreciable property. Infrastructure assets are items that are normally immovable and can be preserved for a greater number of years than most capital assets, such as roads, bridges, streets and sidewalks, drainage systems, and lighting systems. Capital assets increased from the prior year as a result of the retroactive reporting of the historical cost of $63.9 billion in state highway infrastructure and related land.

Table 4 presents a summary of the primary government's capital assets for governmental and business-type activities.

Table 4

Capital Assets
Year ended June 30, 2004
(amounts in millions)

	Governmental Activities	Business-type Activities	Total
Land	$ 14,384	$ 23	$ 14,407
State highway infrastructure	54,468	—	54,468
Collections – nondepreciable	32	—	32
Buildings and other depreciable property	19,019	7,759	26,778
Less: accumulated depreciation	(7,438)	(3,138)	(10,576)
Construction in progress	4,783	1,426	6,209
Total	**$ 85,248**	**$ 6,070**	**$ 91,318**

The budget authorized $2.0 billion for the State's capital outlay program in the 2003-04 fiscal year, not including funding for state highway infrastructure, K-12 schools, and state conservancies. State highway infrastructure assets are discussed in more detail in the Required Supplementary Information that follows the notes to the financial statements. Of the $2.0 billion authorized, $24 million was from the General Fund, $727 million was from lease-revenue bonds, and $1.0 billion was from proceeds of various general obligation bonds. The major capital projects authorized include:

- $1.0 billion for numerous construction projects within the University of California, the California State University, and the California Community Colleges;
- $220 million for the construction of a new facility at the California State Prison, San Quentin, to house the condemned inmate population;
- $160 million to fund the Sacramento Central Plant project;
- $142 million for the Department of Parks and Recreation to allow for planning and execution of various acquisitions, historical restorations, development, and restoration projects; and
- $63 million to construct a 96-bed expansion and a recreation complex at the Porterville Developmental Center.

Additional information on the State's capital assets can be found in Note 7, Capital Assets.

Modified Approach for Infrastructure Assets

The State has elected to use the modified approach to report infrastructure assets of the state highway system. These assets are not depreciated and all expenditures made for them, except for additions and improvements, are expensed in the period incurred. All additions and improvements made after June 30, 2001, are capitalized. All infrastructure assets that are related to projects completed prior to July 1, 2001, are recorded at the historical costs. Under the modified approach, the State must maintain an asset management system and demonstrate that the infrastructure is being preserved at or above established condition levels. The State is responsible for maintaining approximately 49,000 lane miles and 12,000 bridges.

During the 2003-04 fiscal year, the actual amount spent on preservation was 74% of the estimated budgeted amount needed to maintain the infrastructure assets at the established condition levels. Although the amount spent fell short of the budgeted amount, the State's bridges and roadways have assessed conditions that are better than the established condition baselines.

Additional information on the modified approach for infrastructure assets and the State's established condition standards, condition assessments, and preservation costs can be found in the Required Supplementary Information.

Debt Administration

During the 2003-04 fiscal year, the State continued to implement the strategies adopted in its 2002 *Strategic Debt Management Plan*. Under this plan, the State changed how it makes payments on new general obligation bond issuances, by shifting from level principal payments to level debt service payments (principal and interest combined). In addition, the State is deferring the initial principal payments on newly issued general obligation bonds. Although intended to aid in closing the State's near-term budget shortfall, both of these practices individually will result in the primary government incurring increased interest costs in the future because of the delay in paying off outstanding principal balances.

The plan also targeted the restructuring of certain general obligation bonds to achieve one-time reductions in debt service requirements and to facilitate a faster transition to level debt service payments. On July 1, 2003, the State issued general obligation bonds that refunded $870 million of outstanding general obligation bonds. This debt restructuring reduced debt service payments during the 2003-04 fiscal year, but it achieved this reduction by increasing future debt service requirements. On June 29, 2004, the State issued general obligation bonds that current and advance refunded $218 million of outstanding general obligation bonds. The advance refunding resulted in an economic gain of $8.5 million. The economic gain is the difference between the present value of the old debt service requirements and the present value of the new debt service requirements, discounted at 4.1% per year over the life of the bonds.

Lastly, the plan included the issuance of variable-rate debt for a portion of the State's general obligation bond portfolio. The State issued $1.4 billion of variable-rate general obligation bonds in the 2002-03 fiscal year and plans to issue more in the 2004-05 fiscal year. This practice can be beneficial because, historically, variable-rate bonds are issued at rates below those of fixed-rate bonds. Also, when market rates fall, interest rates decrease. However, when market rates rise, so do interest payments on outstanding principal balances.

In March 2004, California's voters passed the Economic Recovery Bond Act, which provided up to $15 billion in one-time financing for the accumulated state budget deficit. The bonds are secured by a pledge of revenues derived from dedicated sales and use taxes. As of June 30, 2004, the State had issued $10.9 billion of these bonds.

At June 30, 2004, the primary government had total bonded debt outstanding of $76.5 billion. Of this amount, $46.1 billion (60.3%) represents general obligation bonds, which are backed by the full faith and credit of the State. The current portion of general obligation bonds outstanding is $1.6 billion and the long-term portion is $44.6 billion. The remaining $30.3 billion (39.7%) of bonded debt outstanding represents revenue bonds, which are secured solely by specified revenue sources. The current portion of revenue bonds outstanding is $965 million and the long-term portion is $29.4 billion. Table 5 presents a summary of the primary government's long-term obligations for governmental and business-type activities.

Table 5

Long-Term Obligations
Year ended June 30, 2004
(amounts in millions)

	Governmental Activities	Business-type Activities	Total
Government-wide noncurrent liabilities			
General obligation bonds	$ 42,611	$ 1,970	$ 44,581
Revenue bonds	8,025	21,351	29,376
Certificates of participation and commercial paper	567	97	664
Capital lease obligations	3,495	—	3,495
Other noncurrent liabilities	9,635	2,495	12,130
Total noncurrent liabilities	**64,333**	**25,913**	**90,246**
Current portion of long-term obligations	2,440	1,727	4,167
Total long-term obligations	**$ 66,773**	**$ 27,640**	**$ 94,413**

The primary government's total long-term obligations increased during the year ended June 30, 2004. The main reason for the increase was the issuance of $4.3 billion in revenue bonds and $17.6 billion in general obligation bonds. The revenue bonds issued consisted of $2.6 billion in Golden State Tobacco Securitization Corporation bonds, $1.2 billion in Bay Area Toll Bridges Seismic Retrofit Bonds, and $615 million in Federal Highway Grant Anticipation Revenue Vehicles (GARVEE bonds). The general obligation bonds issued consisted primarily of $10.9 billion in Economic Recovery Bonds and other general obligation bonds issued to finance the building and repair of education facilities.

In additon to Proposition 57, the Economic Recovery Bond Act, in March 2004 the voters passed Proposition 55, the Kindergarten-University Public Education Facilities Bond Act of 2004. These measures increased the State's authorization to issue bonds by $27.3 billion.

Additional information on the State's long-term obligations can be found in Note 10, Long-Term Obligations, and Notes 11 through 16.

Recent Economic Events and Future Budgets

Recent Economic Conditions

The economy picked up speed in early 2004. Real gross domestic product averaged 3.9% over the four quarters of 2004 and ended the year at a respectable 3.8%. National employment growth, while not spectacular, improved over that of 2003. The promising surge of jobs in the early months of 2004 subsided, but the year still yielded an average increase of almost 183,000 new jobs per month in the nation—a dramatic improvement over the average monthly growth of 7,800 in 2003. While the nation's job growth in 2004 might be described as uneven, California's job growth was even more volatile. Months in which the state lost jobs were followed by those with blockbuster growth. Although the month of December had a job loss, on average the state gained just over 21,000 jobs per month in 2004—a big improvement over the average monthly loss of 5,000 jobs seen in the previous year.

Despite an erratic and generally sluggish job market, California's housing market has continued to soar. The California Association of Realtors (CAR) reported that the median price of a single family home reached $460,370 in October 2004, a 21.4% increase over October 2003. The rapid price increases of the past two years have caused the affordability of homes to decline. In September 2004, CAR estimated that only 19% of Californians could afford to buy a median priced home.

Low affordability levels usually result in the slowing of price increases. The real estate research firm DataQuick reported that Southern California sales in December 2004 were down 6.5% over the previous year. Statewide sales were still above last year's level, but only barely. DataQuick believes that prices in “more expensive neighborhoods have leveled off or come down slightly from a summer peak. In mid-market and entry-level neighborhoods it appears that both sales activity and appreciation remain strong.” The real estate outlook is for a more restrained pace for both sales and price increases in 2005.

The Bay Area, the region hardest hit by the recession of 2001, has begun to see increases in employment. Both the San Francisco and Oakland areas had job gains in September, October, and November, while the San Jose area has achieved stability but not growth. Exports of California-produced computer and electronic products are one of the factors fueling this growth. Exports of California-produced goods and services grew by 17% in 2004, a big improvement over the moderate 2% growth in 2003. The weaker dollar should help maintain this momentum in the months ahead.

Southern California, particularly the Riverside-San Bernardino region, produced the best economic growth in the state during the first half of 2004. International trade and related warehousing have been major factors in the region’s economic growth.

California’s Future Budgets

California's 2004-05 Budget Act was enacted on July 31, 2004. The total spending plan adopted for the State was $105 billion, including the General Fund, special funds, and bond funds. The General Fund's available resources and expenditures were projected to be $80 billion and $78 billion, respectively. To reduce General Fund expenditures by a proposed $13 billion, the State is relying heavily on spending reductions, fund shifts, cost avoidance, bonds, debt service savings, transfers and other revenues, loans and borrowing, and pension reform.

General Fund revenues are predominately taxes, with personal income taxes expected to provide 50% of the revenues. California's major taxes—personal income, sales, and corporation taxes—are projected to supply approximately 93% of the General Fund's budgeted resources in the 2004-05 fiscal year.

In the 2004-05 budget negotiations, California's local governments (cities, counties, redevelopment agencies, and special districts) agreed to transfer $1.3 billion of local property taxes for the benefit of the State in the 2004-05 and 2005-06 fiscal years in exchange for the Administration's support of Proposition 1A, a State Constitutional amendment. In November 2004, Californians approved Proposition 1A, which reduced the Legislature's authority over local government revenues by restricting the State's ability to shift property tax, sales tax, and vehicle license fee revenues after November 3, 2004. The proposition also prohibits the State from mandating activities on local governments without providing the funding needed to comply with the mandates.

In other budget negotiations, the education community agreed to reduce the 2004-05 Proposition 98 school funding guarantee by $2 billion and redirect funding to specified priorities. The Governor also entered into an agreement with higher education that guarantees predictable fees, annual increases in student spending, and accountability measures starting in 2005 for the University of California and the California State University systems.

Because of legal challenges posed, $929 million of pension obligation bonds are not expected to be sold in the 2004-05 fiscal year. The State now proposes to issue $765 million of pension obligation bonds in 2006 to make the 2005-06 fiscal year contributions to the California Public Employees' Retirement System. Proceeds from these pension obligation bonds are expected to provide an equal amount of savings to the General Fund in the year issued.

Governor's Proposed Budget for 2005-06

The Governor released his proposed budget on January 10, 2005. The budget estimates an operating deficit of $8.6 billion in 2005-06 if no corrective actions are taken. The Administration has ten major proposals to achieve a savings of $9.1 billion. These proposals mainly reduce funding for public kindergarten through 12th grade (K-12) education, transportation programs, health and human services, state employee compensation, and local mandate programs. The proposals also include the issuance of an additional $1.7 billion of Economic Recovery Bonds.

The 2005-06 proposed spending plan totals $109 billion, excluding federal funds and bond funds. This represents estimated General Fund expenditures of $86 billion and special fund expenditures of $23 billion. Proposed General Fund expenditures are 4.2% higher than the $82 billion expenditures estimated for the 2004-05 fiscal year.

In its 2005-06 *Overview of the Governor's Budget*, the Legislative Analyst's Office, California's nonpartisan fiscal and policy advisor, notes that the budget proposal has several positive attributes that would provide ongoing savings. However, it was viewed as limited in solutions because "the budget relies nearly entirely on expenditure reductions, targeted on relatively few major areas—namely K-12 education, transportation, and social services." Concerns were also expressed regarding the Administration's proposal for across-the-board reductions to state programs that would not take into consideration program priorities.

Requests for Information

This financial report is designed to provide interested parties with a general overview of the State of California's finances. Questions concerning the information provided in this report or requests for additional information should be addressed to the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250. This report is also available on the Controller's Office Web site at www.sco.ca.gov.

Basic Financial Statements

Government-wide Financial Statements

Statement of Net Assets

June 30, 2004
(amounts in thousands)

	Primary Government			
	Governmental Activities	Business-type Activities	Total	Component Units
ASSETS				
Current assets:				
Cash and pooled investments	$ 14,282,831	$ 3,718,056	$ 18,000,887	$ 3,412,370
Amount on deposit with U.S. Treasury	—	1,407,525	1,407,525	—
Restricted assets:				
Cash and pooled investments	—	2,072,126	2,072,126	—
Investments	—	34,230	34,230	47,113
Due from other governments	—	55,740	55,740	—
Investments	961,935	390,472	1,352,407	11,712,803
Receivables (net)	9,124,318	417,932	9,542,250	2,833,265
Internal balances	237,987	(237,987)	—	—
Due from primary government	—	—	—	188,800
Due from other governments	9,530,408	137,741	9,668,149	887,051
Prepaid items	28,580	6,711	35,291	4,105
Inventories	97,062	22,176	119,238	123,577
Recoverable power costs (net)	—	656,000	656,000	—
Other current assets	175,206	1,209	176,415	156,359
Total current assets	34,438,327	8,681,931	43,120,258	19,365,443
Noncurrent assets:				
Restricted assets:				
Cash and pooled investments	—	1,952,878	1,952,878	29,930
Investments	—	85,533	85,533	13,025
Loans receivable	—	697,323	697,323	—
Other noncurrent assets	—	9,222	9,222	—
Investments	—	2,291,781	2,291,781	25,382,432
Net investment in direct financing leases	—	5,075,218	5,075,218	—
Receivables (net)	893,482	153,371	1,046,853	839,546
Loans receivable	1,629,870	2,946,194	4,576,064	5,420,343
Recoverable power costs (net)	—	7,745,000	7,745,000	—
Deferred charges	188,222	1,397,983	1,586,205	75,102
Capital assets:				
Land	14,383,694	23,256	14,406,950	532,808
State highway infrastructure	54,467,725	—	54,467,725	—
Collections – nondepreciable	32,395	—	32,395	236,478
Buildings and other depreciable property	19,019,287	7,758,759	26,778,046	22,015,571
Less: accumulated depreciation	(7,438,782)	(3,138,262)	(10,577,044)	(10,459,737)
Construction in progress	4,783,191	1,426,442	6,209,633	3,021,869
Other noncurrent assets	—	985	985	372,598
Total noncurrent assets	87,959,084	28,425,683	116,384,767	47,479,965
Total assets	**$ 122,397,411**	**$ 37,107,614**	**$ 159,505,025**	**$ 66,845,408**

The notes to the financial statements are an integral part of this statement.

	Primary Government			
	Governmental Activities	Business-type Activities	Total	Component Units
LIABILITIES				
Current liabilities:				
Accounts payable	$ 11,071,813	$ 596,732	**$ 11,668,545**	$ 1,823,654
Due to component units	188,800	—	**188,800**	—
Due to other governments	6,938,621	115,095	**7,053,716**	141,896
Dividends payable	—	—	**—**	7,200
Deferred revenue	3,494	38,938	**42,432**	661,810
Tax overpayments	3,008,382	—	**3,008,382**	—
Deposits	88,553	5,105	**93,658**	421,715
Contracts and notes payable	17,744	—	**17,744**	9,454
Advance collections	673,563	40,806	**714,369**	299,694
Interest payable	591,028	196,632	**787,660**	118,506
Securities lending obligations	—	—	**—**	4,513,823
Benefits payable	—	354,007	**354,007**	3,057,153
Current portion of long-term obligations	2,440,135	1,727,355	**4,167,490**	2,323,264
Other current liabilities	1,079,057	78,083	**1,157,140**	1,658,252
Total current liabilities	26,101,190	3,152,753	**29,253,943**	15,036,421
Noncurrent liabilities:				
Loans payable	880,226	—	**880,226**	5,165
Benefits payable	—	19,449	**19,449**	10,249,482
Lottery prizes and annuities	—	1,883,851	**1,883,851**	—
Compensated absences payable	1,435,096	31,770	**1,466,866**	233,911
Certificates of participation, commercial paper, and other borrowings	567,310	97,179	**664,489**	304,524
Capital lease obligations	3,495,042	—	**3,495,042**	1,205,011
General obligation bonds payable	42,610,589	1,970,105	**44,580,694**	—
Revenue bonds payable	8,025,230	21,350,653	**29,375,883**	12,033,782
Other noncurrent liabilities	7,319,565	559,464	**7,879,029**	1,384,318
Total noncurrent liabilities	64,333,058	25,912,471	**90,245,529**	25,416,193
Total liabilities	**90,434,248**	**29,065,224**	**119,499,472**	**40,452,614**
NET ASSETS				
Investment in capital assets, net of related debt	77,734,545	1,058,136	**78,792,681**	8,243,562
Restricted:				
Nonexpendable – endowments	—	—	**—**	2,467,650
Expendable:				
Endowments	—	—	**—**	4,584,959
Business and transportation	2,145,779	197,139	**2,342,918**	1,390,738
Resources	1,831,606	1,834,412	**3,666,018**	—
Health and human services	1,201,205	81,035	**1,282,240**	—
Education	1,096,087	368,487	**1,464,574**	1,849,651
General government	781,362	661,944	**1,443,306**	114,136
Unemployment programs	69,974	2,524,606	**2,594,580**	—
Workers' compensation liability	—	—	**—**	2,048,295
Total expendable	7,126,013	5,667,623	12,793,636	9,987,779
Unrestricted	(52,897,395)	1,316,631	**(51,580,764)**	5,693,803
Total net assets	**31,963,163**	**8,042,390**	40,005,553	**26,392,794**
Total liabilities and net assets	**$ 122,397,411**	**$ 37,107,614**	$ 159,505,025	**$ 66,845,408**

The notes to the financial statements are an integral part of this statement.

Statement of Activities

Year Ended June 30, 2004
(amounts in thousands)

FUNCTIONS/PROGRAMS	Expenses	Program Revenues: Charges for Services	Program Revenues: Operating Grants and Contributions	Program Revenues: Capital Grants and Contributions
Primary government				
Governmental activities:				
General government	$ 8,010,598	$ 4,384,986	$ 1,293,180	$ —
Education	51,457,841	2,631,859	5,589,830	—
Health and human services	60,020,524	1,751,752	30,279,739	—
Resources	4,436,309	1,544,260	196,000	—
State and consumer services	1,029,460	496,561	7,450	—
Business and transportation	7,579,221	2,295,747	2,611,884	916,961
Correctional programs	6,214,862	13,915	1,094,330	—
Tax relief	3,007,026	1,982	—	—
Interest on long-term debt	1,737,696	—	—	—
Total governmental activities	143,493,537	13,121,062	41,072,413	916,961
Business-type activities:				
Electric Power	5,203,000	5,203,000	—	—
Water Resources	731,099	714,647	—	—
Public Building Construction	296,502	307,910	—	—
State Lottery	3,347,644	3,143,408	—	—
Unemployment Programs	10,271,962	9,631,916	—	—
High Technology Education	37,261	34,052	—	—
Toll Facilities	18,968	121	—	—
State University Dormitory Building Maintenance and Equipment	426,187	250,208	—	—
State Water Pollution Control Revolving	15,131	51,687	—	47,528
Housing Loan	173,629	143,805	—	—
Other enterprise programs	98,654	114,081	—	—
Total business-type activities	20,620,037	19,594,835	—	47,528
Total primary government	**$ 164,113,574**	**$ 32,715,897**	**$ 41,072,413**	**$ 964,489**
Component units:				
University of California	$ 18,598,411	$ 12,342,686	$ 3,826,641	$ —
State Compensation Insurance Fund	7,598,812	8,022,356	—	—
California Housing Finance Agency	494,567	476,430	112,735	—
Nonmajor component units	4,733,497	4,076,061	461,440	—
Total component units	**$ 31,425,287**	**$ 24,917,533**	**$ 4,400,816**	**$ —**

General revenues:
- Personal income taxes
- Sales and use taxes
- Corporation taxes
- Insurance taxes
- Other taxes
- Investment and interest
- Escheat
- Miscellaneous

Transfers

Nonoperating grants and gifts

Total general and other revenues and transfers

Change in net assets

Net assets, July 1, 2003 (restated)

Net assets, June 30, 2004

The notes to the financial statements are an integral part of this statement.

Net (Expenses) Revenues and Changes in Net Assets			
Primary Government			
Governmental Activities	**Business-type Activities**	**Total**	**Component Units**
$ (2,332,432)		**$ (2,332,432)**	
(43,236,152)		**(43,236,152)**	
(27,989,033)		**(27,989,033)**	
(2,696,049)		**(2,696,049)**	
(525,449)		**(525,449)**	
(1,754,629)		**(1,754,629)**	
(5,106,617)		**(5,106,617)**	
(3,005,044)		**(3,005,044)**	
(1,737,696)		**(1,737,696)**	
(88,383,101)		**(88,383,101)**	
	$ —	**—**	
	(16,452)	**(16,452)**	
	11,408	**11,408**	
	(204,236)	**(204,236)**	
	(640,046)	**(640,046)**	
	(3,209)	**(3,209)**	
	(18,847)	**(18,847)**	
	(175,979)	**(175,979)**	
	84,084	**84,084**	
	(29,824)	**(29,824)**	
	15,427	**15,427**	
	(977,674)	**(977,674)**	
(88,383,101)	**(977,674)**	**(89,360,775)**	
			$ (2,429,084)
			423,544
			94,598
			(195,996)
			(2,106,938)
37,926,550	—	**37,926,550**	—
28,651,768	—	**28,651,768**	—
9,027,816	—	**9,027,816**	—
2,119,315	—	**2,119,315**	—
2,329,987	—	**2,329,987**	—
155,430	—	**155,430**	—
598,681	—	**598,681**	—
87,663	—	**87,663**	—
32,965	(32,965)	**—**	—
—	—	**—**	4,362,257
80,930,175	**(32,965)**	**80,897,210**	**4,362,257**
(7,452,926)	(1,010,639)	**(8,463,565)**	2,255,319
39,416,089	**9,053,029**	**48,469,118**	**24,137,475**
$ 31,963,163	**$ 8,042,390**	**$ 40,005,553**	**$ 26,392,794**

The notes to the financial statements are an integral part of this statement.

Fund Financial Statements

Balance Sheet

Governmental Funds

June 30, 2004
(amounts in thousands)

	General	Federal	Transportation Construction	Nonmajor Governmental	Total
ASSETS					
Cash and pooled investments	$ 3,585,245	$ 243,495	$ 2,087,012	$ 7,893,161	$ 13,808,913
Investments	—	—	—	961,935	961,935
Receivables (net)	7,470,169	10,182	344,333	1,242,138	9,066,822
Due from other funds	827,495	67	1,201,057	1,261,458	3,290,077
Due from other governments	715,910	8,664,815	7,720	133,885	9,522,330
Interfund receivables	41,628	—	648,900	2,413,435	3,103,963
Loans receivable	105,813	43,986	—	1,456,640	1,606,439
Other assets	41,673	—	68,102	59,569	169,344
Total assets	**$ 12,787,933**	**$ 8,962,545**	**$ 4,357,124**	**$ 15,422,221**	**$ 41,529,823**
LIABILITIES					
Accounts payable	$ 1,015,884	$ 912,779	$ 150,549	$ 2,330,765	$ 4,409,977
Due to other funds	3,360,409	5,229,606	151,409	645,159	9,386,583
Due to component units	113,759	—	—	73,013	186,772
Due to other governments	2,866,390	2,713,661	144,935	1,272,030	6,997,016
Deferred revenue	—	—	—	3,494	3,494
Interfund payables	3,297,603	—	—	662,749	3,960,352
Tax overpayments	3,000,271	—	—	8,111	3,008,382
Deposits	1,772	—	10,401	75,318	87,491
Contracts and notes payable	—	—	—	2,414	2,414
Advance collections	34,051	48,464	5,479	370,909	458,903
Interest payable	15,344	—	28,615	33,841	77,800
Other liabilities	623,150	2,376	221,544	589,564	1,436,634
Total liabilities	**14,328,633**	**8,906,886**	**712,932**	**6,067,367**	**30,015,818**
FUND BALANCES					
Reserved for:					
Encumbrances	641,453	—	2,387,779	3,606,732	6,635,964
Interfund receivables	41,628	—	648,900	2,413,435	3,103,963
Loans receivable	105,813	43,986	—	1,456,640	1,606,439
Continuing appropriations	902,140	—	2,221,388	1,846,196	4,969,724
Unreserved, reported in:					
General Fund	(3,231,734)	—	—	—	(3,231,734)
Special revenue funds	—	11,673	(1,613,875)	258,770	(1,343,432)
Capital projects funds	—	—	—	(226,919)	(226,919)
Total fund balances (deficits)	**(1,540,700)**	**55,659**	**3,644,192**	**9,354,854**	**11,514,005**
Total liabilities and fund balances	**$ 12,787,933**	**$ 8,962,545**	**$ 4,357,124**	**$ 15,422,221**	

The notes to the financial statements are an integral part of this statement.

Reconciliation of the Governmental Funds Balance Sheet to the Statement of Net Assets

(amounts in thousands)

Total fund balances – governmental funds		**$ 11,514,005**
Amounts reported for governmental activities in the Statement of Net Assets are different because:		
Capital assets used in governmental activities are not financial resources and, therefore, are not reported in the funds.		84,786,985
Other long-term assets are not available to pay for current-period expenditures and, therefore, are not reported.		893,482
Internal service funds are used by management to charge the costs of certain activities, such as fleet management and management information systems, to individual funds. The assets and liabilities of the internal service funds are included in governmental activities in the Statement of Net Assets.		614,595
Deferred bond issue costs, discounts, and premiums are reported as current expenditures in the funds. However, deferred issue costs and net discounts are amortized over the life of the bonds and are included in the governmental activities in the Statement of Net Assets.		188,222
General obligation bonds totaling $44,437,864 and revenue bonds totaling $8,101,855 are not due and payable in the current period and, therefore, are not reported in the funds.		(52,539,719)
Certain long-term liabilities are not due and payable in the current period and, therefore, adjustments to these liabilities are not reported in the funds:		
Compensated absences adjustments	(1,484,420)	
Certificates of participation and commercial paper adjustments	(849,360)	
Capital lease adjustments	(3,736,036)	
Other long-term obligations	(7,424,591)	
		(13,494,407)
Net assets of governmental activities		**$ 31,963,163**

Statement of Revenues, Expenditures, and Changes in Fund Balances

Governmental Funds

Year Ended June 30, 2004
(amounts in thousands)

	General	Federal	Transportation Construction	Nonmajor Governmental	Total
REVENUES					
Personal income taxes	$ 37,722,839	$ —	$ —	$ —	$ 37,722,839
Sales and use taxes	23,846,748	—	2,316,527	2,522,325	28,685,600
Corporation taxes	8,379,316	—	—	—	8,379,316
Insurance taxes	2,119,315	—	—	—	2,119,315
Other taxes	822,336	—	—	1,599,990	2,422,326
Intergovernmental	3,763	41,071,921	—	1,843,298	42,918,982
Licenses and permits	49,097	—	808,836	2,611,808	3,469,741
Charges for services	122,394	—	125,389	671,497	919,280
Fees	82,357	—	—	3,933,195	4,015,552
Penalties	25,724	491	—	621,126	647,341
Investment and interest	139,700	—	25,975	212,019	377,694
Escheat	598,681	—	—	—	598,681
Other	780,626	—	53,966	2,165,228	2,999,820
Total revenues	**74,692,896**	**41,072,412**	**3,330,693**	**16,180,486**	**135,276,487**
EXPENDITURES					
Current:					
General government	2,033,317	1,177,041	7,302	4,810,739	8,028,399
Education	36,349,973	6,124,758	980	7,050,852	49,526,563
Health and human services	23,555,792	29,474,853	—	6,789,629	59,820,274
Resources	947,332	235,288	12	2,503,451	3,686,083
State and consumer services	460,431	9,195	—	465,801	935,427
Business and transportation	8,918	2,612,199	3,542,506	2,955,614	9,119,237
Correctional programs	5,230,381	1,004,659	—	1,685	6,236,725
Tax relief	2,983,818	—	—	—	2,983,818
Capital outlay	85,390	—	11,006	1,149,475	1,245,871
Debt service:					
Bond and commercial paper retirement	450,749	—	3,335	930,511	1,384,595
Interest and fiscal charges	1,608,197	—	12,312	66,267	1,686,776
Total expenditures	**73,714,298**	**40,637,993**	**3,577,453**	**26,724,024**	**144,653,768**
Excess (deficiency) of revenues over (under) expenditures	978,598	434,419	(246,760)	(10,543,538)	(9,377,281)
OTHER FINANCING SOURCES (USES)					
General obligation bonds and commercial paper issued	—	—	18,900	18,366,580	18,385,480
Revenue bonds issued	—	—	1,775,285	2,572,285	4,347,570
Refunding bonds issued	—	—	43,130	1,040,745	1,083,875
Remarketing bonds issued	—	—	—	100,000	100,000
Payment to refunding agent	—	—	(43,130)	(1,040,745)	(1,083,875)
Payment to remarketing agent	—	—	—	(100,000)	(100,000)
Capital leases	85,390	—	—	—	85,390
Transfers in	13,983,409	—	15,784	4,475,839	18,475,032
Transfers out	(3,220,299)	(985,798)	(14,760)	(14,207,707)	(18,428,564)
Total other financing sources (uses)	**10,848,500**	**(985,798)**	**1,795,209**	**11,206,997**	**22,864,908**
Net change in fund balances	11,827,098	(551,379)	1,548,449	663,459	13,487,627
Fund balances (deficits), July 1, 2003	**(13,367,798)**	**607,038**	**2,095,743**	**8,691,395 ***	**(1,973,622) ***
Fund balances (deficits), June 30, 2004	**$ (1,540,700)**	**$ 55,659**	**$ 3,644,192**	**$ 9,354,854**	**$ 11,514,005**

* Restated

The notes to the financial statements are an integral part of this statement.

Reconciliation of the Statement of Revenues, Expenditures, and Changes in Fund Balances of Governmental Funds to the Statement of Activities

(amounts in thousands)

Net change in fund balances – total governmental funds		**$ 13,487,627**
Amounts reported for governmental activities in the Statement of Activities are different because:		
Governmental funds report capital outlays as expenditures. However, in the Statement of Activities, the cost of those assets is allocated over their estimated useful lives as depreciation expense. This is the amount by which capital outlays exceed depreciation in the current period.		2,015,836
Revenues in the Statement of Activities that do not provide current financial resources are deferred and not reported as revenues in the funds.		81,160
Bonds and other noncurrent financing instruments provide current financial resources to governmental funds in the form of debt, which increases long-term liabilities in the Statement of Net Assets. Repayment of bond principal is an expenditure in the governmental funds, but the repayment reduces long-term liabilities in the Statement of Net Assets. The following amounts represent the difference between proceeds and repayments.		
General obligation bond adjustments	(17,270,853)	
Revenue bond adjustments	(4,253,540)	
Certificates of participation and commercial paper adjustments	73,092	
		(21,451,301)
Some expenses reported in the Statement of Activities do not require the use of current financial resources and, therefore, are not reported as expenditures in governmental funds.		
Compensated absences	(106,517)	
Lease adjustments	157,220	
Other long-term obligations	(1,614,467)	
		(1,563,764)
Internal service funds are used by management to charge the costs of certain activities, such as fleet management and management information systems, to individual funds. The net revenue (expense) of the internal service funds is reported with governmental activities.		(22,484)
Change in net assets of governmental activities		**$ (7,452,926)**

The notes to the financial statements are an integral part of this statement.

Statement of Net Assets

Proprietary Funds

June 30, 2004
(amounts in thousands)

	Electric Power	Water Resources
ASSETS		
Current assets:		
Cash and pooled investments	$ —	$ 269,996
Amount on deposit with U.S. Treasury	—	—
Restricted assets:		
Cash and pooled investments	1,859,000	—
Investments	—	—
Due from other governments	—	—
Investments	33,000	—
Receivables (net)	—	86,648
Due from other funds	15,000	1,761
Due from other governments	—	7,978
Prepaid items	—	—
Inventories	—	10,227
Recoverable power costs (net)	656,000	—
Other current assets	—	66
Total current assets	2,563,000	376,676
Noncurrent assets:		
Restricted assets:		
Cash and pooled investments	1,522,000	153,295
Investments	—	48,830
Loans receivable	—	—
Other noncurrent assets	—	—
Investments	—	—
Net investment in direct financing leases	—	—
Receivables	104,000	—
Interfund receivables	—	91,516
Loans receivable	—	32,981
Recoverable power costs (net)	7,745,000	—
Deferred charges	—	1,290,133
Capital assets:		
Land	—	—
Buildings and other depreciable property	—	4,560,047
Less: accumulated depreciation	—	(1,566,792)
Construction in progress	—	37,101
Other noncurrent assets	—	—
Total noncurrent assets	9,371,000	4,647,111
Total assets	**$ 11,934,000**	**$ 5,023,787**

The notes to the financial statements are an integral part of this statement.

Business-type Activities – Enterprise Funds					Governmental Activities
Public Building Construction	State Lottery	Unemployment Programs	Nonmajor Enterprise	Total	Internal Service Funds
$ —	$ 267,391	$ 1,399,291	$ 1,781,378	**$ 3,718,056**	$ 473,918
—	—	1,407,525	—	**1,407,525**	—
54,437	—	—	158,689	**2,072,126**	—
—	—	—	34,230	**34,230**	—
—	—	—	55,740	**55,740**	—
—	357,472	—	—	**390,472**	—
118,116	151,110	143,414	46,961	**546,249**	40,883
11,648	2,266	9,355	5,091	**45,121**	292,122
—	—	57,256	72,507	**137,741**	8,078
—	6,573	—	138	**6,711**	28,580
—	8,256	—	3,693	**22,176**	97,062
—	—	—	—	**656,000**	—
—	—	—	1,143	**1,209**	5,862
184,201	793,068	3,016,841	2,159,570	**9,093,356**	946,505
253,838	—	—	23,745	**1,952,878**	—
—	—	—	36,703	**85,533**	—
—	—	—	697,323	**697,323**	—
—	—	—	9,222	**9,222**	—
—	2,130,041	—	161,740	**2,291,781**	—
4,685,272	—	—	389,946	**5,075,218**	—
—	—	49,371	—	**153,371**	—
—	—	—	9,499	**101,015**	—
—	—	—	2,913,213	**2,946,194**	—
—	—	—	—	**7,745,000**	—
64,254	27,954	—	15,642	**1,397,983**	—
—	4,923	—	18,333	**23,256**	231
—	91,001	9,502	3,098,209	**7,758,759**	1,193,250
—	(57,851)	(4,368)	(1,509,251)	**(3,138,262)**	(736,106)
1,112,721	—	—	276,620	**1,426,442**	3,150
—	—	—	985	**985**	—
6,116,085	2,196,068	54,505	6,141,929	**28,526,698**	460,525
$ 6,300,286	**$ 2,989,136**	**$ 3,071,346**	**$ 8,301,499**	**$ 37,620,054**	**$ 1,407,030**

(continued)

Statement of Net Assets (continued)

Proprietary Funds

June 30, 2004
(amounts in thousands)

	Electric Power	Water Resources
LIABILITIES		
Current liabilities:		
Accounts payable	$ 452,000	$ 39,156
Due to other funds	—	34,640
Due to component units	—	—
Due to other governments	—	89,693
Deferred revenue	—	—
Deposits	—	—
Contracts and notes payable	—	—
Advance collections	—	—
Interest payable	68,000	20,942
Benefits payable	—	—
Current portion of long-term obligations	432,000	114,395
Other current liabilities	—	—
Total current liabilities	952,000	298,826
Noncurrent liabilities:		
Interfund payables	—	—
Benefits payable	—	—
Lottery prizes and annuities	—	—
Compensated absences payable	—	—
Certificates of participation, commercial paper, and other borrowings	—	10,519
Capital lease obligations	—	—
General obligation bonds payable	—	731,290
Revenue bonds payable	10,982,000	2,393,211
Other noncurrent liabilities	—	403,399
Total noncurrent liabilities	10,982,000	3,538,419
Total liabilities	**11,934,000**	**3,837,245**
NET ASSETS		
Investment in capital assets, net of related debt	—	185,676
Restricted – Expendable:		
Construction	—	1,000,866
Debt service	—	—
Future loan disbursement	—	—
Security for revenue bonds	—	—
Lottery	—	—
Unemployment program	—	—
Other purposes	—	—
Total expendable	—	1,000,866
Unrestricted	—	—
Total net assets	**—**	**1,186,542**
Total liabilities and net assets	**$ 11,934,000**	**$ 5,023,787**

The notes to the financial statements are an integral part of this statement.

Business-type Activities – Enterprise Funds					Governmental Activities
Public Building Construction	**State Lottery**	**Unemployment Programs**	**Nonmajor Enterprise**	**Total**	**Internal Service Funds**
$ 43,772	$ 23,084	$ —	$ 34,259	**$ 592,271**	$ 152,327
59,673	238,493	106,017	74,331	**513,154**	224,938
—	—	—	—	**—**	2,028
215	—	12,964	12,223	**115,095**	—
—	—	—	38,938	**38,938**	—
—	—	—	5,105	**5,105**	1,062
—	—	—		**—**	15,330
24,682	2,109	—	14,015	**40,806**	214,660
58,259	—	—	49,431	**196,632**	—
—	—	354,007	—	**354,007**	—
293,794	576,812	—	310,354	**1,727,355**	14,861
—	651	65,824	11,608	**78,083**	4,773
480,395	841,149	538,812	550,264	**3,661,446**	629,979
—	—	—	3,747	**3,747**	97,674
—	—	—	19,449	**19,449**	—
—	1,883,851	—	—	**1,883,851**	—
—	4,385	7,864	19,521	**31,770**	36,051
—	—	—	86,660	**97,179**	—
—	—	—	—	**—**	5,441
—	—	—	1,238,815	**1,970,105**	—
5,739,568	—	—	2,235,874	**21,350,653**	—
—	1,986	—	154,079	**559,464**	23,290
5,739,568	1,890,222	7,864	3,758,145	**25,916,218**	162,456
6,219,963	**2,731,371**	**546,676**	**4,308,409**	**29,577,664**	**792,435**
—	38,072	5,134	829,254	**1,058,136**	460,525
60,757	—	—	234,405	**1,296,028**	—
19,566	—	—	154,381	**173,947**	—
—	—	—	77,884	**77,884**	—
—	—	—	753,063	**753,063**	—
—	257,765	—	—	**257,765**	—
—	—	2,524,606	—	**2,524,606**	—
—	—	—	584,330	**584,330**	—
80,323	257,765	2,524,606	1,804,063	**5,667,623**	—
—	(38,072)	(5,070)	1,359,773	**1,316,631**	154,070
80,323	**257,765**	**2,524,670**	**3,993,090**	**8,042,390**	**614,595**
$ 6,300,286	**$ 2,989,136**	**$ 3,071,346**	**$ 8,301,499**	**$ 37,620,054**	**$ 1,407,030**

(concluded)

The notes to the financial statements are an integral part of this statement.

Statement of Revenues, Expenses, and Changes in Fund Net Assets

Proprietary Funds

Year Ended June 30, 2004
(amounts in thousands)

	Electric Power	Water Resources
OPERATING REVENUES		
Unemployment and disability insurance	$ —	$ —
Lottery ticket sales	—	—
Power sales	4,308,000	59,289
Student tuition and fees	—	—
Services and sales	—	655,358
Investment and interest	—	—
Rent	—	—
Other	—	—
Total operating revenues	**4,308,000**	**714,647**
OPERATING EXPENSES		
Lottery prizes	—	—
Power purchases (net of recoverable power costs)	4,249,000	143,151
Personal services	—	202,280
Supplies	—	—
Services and charges	59,000	135,762
Depreciation	—	77,388
Distributions to beneficiaries	—	—
Interest expense	—	—
Amortization of deferred charges	—	—
Other	—	—
Total operating expenses	**4,308,000**	**558,581**
Operating income (loss)	—	156,066
NONOPERATING REVENUES (EXPENSES)		
Investment and interest income	895,000	—
Interest expense and fiscal charges	(895,000)	(167,873)
Lottery payments for education	—	—
Other	—	(4,645)
Total nonoperating revenues (expenses)	**—**	**(172,518)**
Income (loss) before contributions and transfers	—	(16,452)
Capital contributions	—	—
Transfers in	—	—
Transfers out	—	—
Change in net assets	—	(16,452)
Total net assets, July 1, 2003	**—**	**1,202,994**
Total net assets, June 30, 2004	**$ —**	**$ 1,186,542**

* Restated

The notes to the financial statements are an integral part of this statement.

Business-type Activities – Enterprise Funds					Governmental Activities
Public Building Construction	**State Lottery**	**Unemployment Programs**	**Nonmajor Enterprise**	**Total**	**Internal Service Funds**
$ —	$ —	$ 8,557,253	$ —	**$ 8,557,253**	$ —
—	2,973,976	—	—	**2,973,976**	—
—	—	—	—	**4,367,289**	—
—	—	—	232,211	**232,211**	—
—	—	981,188	90,346	**1,726,892**	2,096,238
8,494	—	—	176,367	**184,861**	64
299,401	—	—	58,461	**357,862**	—
15	—	—	11,041	**11,056**	—
307,910	**2,973,976**	**9,538,441**	**568,426**	**18,411,400**	**2,096,302**
—	1,566,027	—	—	**1,566,027**	—
—	—	—	—	**4,392,151**	—
—	40,760	189,976	83,954	**516,970**	634,956
—	12,250	—		**12,250**	32,579
18,480	309,415	73,713	171,086	**767,456**	1,348,367
—	8,161	505	181,926	**267,980**	85,046
—	—	10,007,768	—	**10,007,768**	—
271,836	—	—	235,871	**507,707**	1,295
6,186	236	—	305	**6,727**	—
—	—	—	33,365	**33,365**	—
296,502	**1,936,849**	**10,271,962**	**706,507**	**18,078,401**	**2,102,243**
11,408	1,037,127	(733,521)	(138,081)	**332,999**	(5,941)
—	169,186	93,475	20,161	**1,177,822**	2,327
—	(366,733)	—	(11,050)	**(1,440,656)**	(2)
—	(1,044,062)	—	—	**(1,044,062)**	—
—	246	—	(46,906)	**(51,305)**	(608)
—	**(1,241,363)**	**93,475**	**(37,795)**	**(1,358,201)**	**1,717**
11,408	(204,236)	(640,046)	(175,876)	**(1,025,202)**	(4,224)
—	—	—	47,528	**47,528**	333
147	—	14,017	19,460	**33,624**	—
—	—	—	(66,589)	**(66,589)**	(18,593)
11,555	(204,236)	(626,029)	(175,477)	**(1,010,639)**	(22,484)
68,768	**462,001**	**3,150,699**	**4,168,567** *	**9,053,029** *	**637,079** *
$ 80,323	**$ 257,765**	**$ 2,524,670**	**$ 3,993,090**	**$ 8,042,390**	**$ 614,595**

The notes to the financial statements are an integral part of this statement.

Statement of Cash Flows

Proprietary Funds

Year Ended June 30, 2004
(amounts in thousands)

	Electric Power	Water Resources
CASH FLOWS FROM OPERATING ACTIVITIES		
Receipts from customers/employers	$ 4,836,000	$ 728,995
Receipts from interfund services provided	—	—
Payments to suppliers	(5,144,000)	(309,985)
Payments to employees	—	(202,280)
Payments for interfund services used	—	—
Payments for Lottery prizes	—	—
Claims paid to other than employees	—	—
Other receipts (payments)	133,000	—
Net cash provided by (used in) operating activities	**(175,000)**	**216,730**
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES		
Changes in interfund payables and loans payable	—	—
Proceeds from revenue bonds	—	—
Retirement of general obligation bonds	—	—
Retirement of revenue bonds	(180,000)	—
Interest paid on operating debt	(465,000)	—
Transfers in	—	—
Transfers out	—	—
Grants received	—	—
Lottery payments for education	—	—
Other	776,000	(12,772)
Net cash provided by (used in) noncapital financing activities	**131,000**	**(12,772)**
CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES		
Changes in interfund payables and loans payable	—	—
Acquisition of intangible assets	—	(15,772)
Acquisition of capital assets	—	—
Proceeds from sale of capital assets	—	—
Proceeds from notes payable and commercial paper	—	70,643
Principal paid on notes payable and commercial paper	—	(92,218)
Payment of capital lease obligations	—	—
Retirement of general obligation bonds	—	(44,480)
Proceeds from revenue bonds	—	186,898
Retirement of revenue bonds	—	(145,980)
Interest paid	—	(157,663)
Contributed capital	—	—
Net cash provided by (used in) capital and related financing activities	**—**	**(198,572)**
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of investments	(20,000)	—
Proceeds from maturity and sale of investments	—	—
Change in interfund receivables and loans receivable	—	4,264
Earnings on investments	95,000	11,240
Net cash provided by (used in) investing activities	**75,000**	**15,504**
Net increase (decrease) in cash and pooled investments	31,000	20,890
Cash and pooled investments at July 1, 2003	**3,350,000**	**402,401**
Cash and pooled investments at June 30, 2004	**$ 3,381,000**	**$ 423,291**

* Restated

The notes to the financial statements are an integral part of this statement.

Business-type Activities – Enterprise Funds					Governmental Activities
Public Building Construction	**State Lottery**	**Unemployment Programs**	**Nonmajor Enterprise**	**Total**	**Internal Service Funds**
$ 495,926	$ 2,957,163	$ 9,512,586	$ 621,701	$ 19,152,371	$ 2,098,776
—	—	—	13,547	13,547	96,882
(18,829)	(363,572)	(73,713)	(205,256)	(6,115,355)	(1,413,020)
—	(38,321)	(189,751)	(63,321)	(493,673)	(593,640)
—	(4,213)	—	(8,376)	(12,589)	(212,593)
—	(1,740,260)	—	—	(1,740,260)	—
—	—	(10,119,134)	(419)	(10,119,553)	(10,137)
(268,628)	201	35,631	(173,924)	(273,720)	(6,297)
208,469	**810,998**	**(834,381)**	**183,952**	**410,768**	**(40,029)**
—	—	—	16,002	16,002	(376)
—	—	—	124,635	124,635	—
—	—	—	(548,995)	(548,995)	—
—	—	—	(28,665)	(208,665)	—
—	—	—	(12,412)	(477,412)	—
147	—	14,017	11,102	25,266	—
—	—	—	(46,690)	(46,690)	(18,593)
—	—	—	41,832	41,832	—
—	(1,065,602)	—	—	(1,065,602)	—
—	—	—	(30,552)	732,676	196
147	**(1,065,602)**	**14,017**	**(473,743)**	**(1,406,953)**	**(18,773)**
(16,024)	—	—	—	(16,024)	—
—	—	—	—	(15,772)	(659)
(854,802)	(2,564)	(11)	(217,498)	(1,074,875)	(70,421)
—	22	—		22	533
—	—	—	—	70,643	—
—	—	—	—	(92,218)	(5,395)
—	—	—	—	—	(2,445)
—	—	—	—	(44,480)	—
1,249,705	—	—	217,315	1,653,918	—
(560,964)	—	—	(149,523)	(856,467)	—
—	—	—	—	(157,663)	(1,295)
—	—	—	—	—	333
(182,085)	**(2,542)**	**(11)**	**(149,706)**	**(532,916)**	**(79,349)**
—	(90,119)	—		(110,119)	—
—	357,184	1,377,586	106,085	1,840,855	—
—	—	—	(6,287)	(2,023)	—
—	8,962	93,475	21,475	230,152	2,413
—	**276,027**	**1,471,061**	**121,273**	**1,958,865**	**2,413**
26,531	18,881	650,686	(318,224)	429,764	(135,738)
281,744	**248,510**	**748,605**	**2,282,036** *	**7,313,296** *	**609,656**
$ 308,275	**$ 267,391**	**$ 1,399,291**	**$ 1,963,812**	**$ 7,743,060**	**$ 473,918**

(continued)

Statement of Cash Flows (continued)

Proprietary Funds

Year Ended June 30, 2004
(amounts in thousands)

	Electric Power	Water Resources
RECONCILIATION OF OPERATING INCOME (LOSS) TO NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES		
Operating income (loss)	$ —	$ 156,066
Adjustments to reconcile operating income (loss) to net cash provided by (used in) operating activities:		
Interest expense on operating debt	—	—
Depreciation	—	77,388
Accretion of capital appreciation bonds	—	—
Provisions and allowances	—	—
Accrual of deferred charges	—	—
Amortization of discounts	—	—
Amortization of deferred charges	—	(23,099)
Other	—	—
Change in assets and liabilities:		
Receivables	—	(3,237)
Due from other funds	21,000	—
Due from other governments	—	—
Prepaid items	—	—
Inventories	—	(1,467)
Net investment in direct financing leases	—	—
Recoverable power costs (net)	(233,000)	—
Other current assets	—	8,950
Loans receivable	—	—
Interfund receivable	—	—
Accounts payable	37,000	11,587
Due to other funds	—	(24,811)
Due to component units	—	—
Due to other governments	—	14,739
Deposits	—	—
Advance collections	—	—
Interest payable	—	—
Other current liabilities	—	—
Deferred revenue	—	—
Benefits payable	—	—
Lottery prizes and annuities	—	—
Compensated absences payable	—	614
Capital lease obligations	—	—
Other noncurrent liabilities	—	—
Total adjustments	(175,000)	60,664
Net cash provided by (used in) operating activities	**$ (175,000)**	**$ 216,730**
Noncash capital and related financing and investing activities		
Interest accreted on annuitized prizes	$ —	$ —
Unclaimed Lottery prizes directly transferred to Education Fund	—	—
Unrealized loss on investment	—	—
Gain on investment	—	—
Loans Receivable contributed	—	—

The notes to the financial statements are an integral part of this statement.

Business-type Activities – Enterprise Funds					Activities
Public Building Construction	**State Lottery**	**Unemployment Programs**	**Nonmajor Enterprise**	**Total**	**Internal Service Funds**
$ 11,408	$ 1,037,127	$ (733,521)	$ (138,081)	$ 332,999	$ (5,941)
—	—	—	—	—	1,295
—	8,161	505	181,926	267,980	85,046
2,890	—	—	4,321	7,211	—
—	5,840	—	(1,993)	3,847	—
(13,475)	(27,920)	—	—	(41,395)	—
(2,359)	—	—	—	(2,359)	—
6,186	236	—	8,991	(7,686)	—
9,594	419	—	5,074	15,087	1,050
—	(22,690)	(20,700)	(13,946)	(60,573)	74,591
(8,396)	(588)	(20,883)	17,640	8,773	9,977
—	—	(18,286)	(2,831)	(21,117)	(693)
—	—	—	(57)	(57)	(2,133)
—	(3,355)	—	(1,591)	(6,413)	(759)
206,442	—	—	24,338	230,780	—
—	—	—	—	(233,000)	—
—	(6,081)	—	5,477	8,346	2,810
—	—	—	62,365	62,365	—
—	—	—	499	499	—
252	(7,554)	—	(5,976)	35,309	12,449
(175)	(10)	56,690	19,353	51,047	(184,047)
—	—	—	—	—	166
(343)	—	(5,168)	5,114	14,342	—
—	(10)	—	716	706	127
(935)	—	—	1,529	594	(40,447)
(2,620)	—	—	2,288	(332)	—
—	—	12,955	(4,203)	8,752	(562)
—	—	—	16,210	16,210	—
—	—	(106,198)	(2,486)	(108,684)	—
—	(174,232)	—	—	(174,232)	—
—	1,596	225	10,643	13,078	8,016
—	—	—	—	—	(1,347)
—	59	—	(11,368)	(11,309)	373
197,061	(226,129)	(100,860)	322,033	77,769	(34,088)
$ 208,469	**$ 810,998**	**$ (834,381)**	**$ 183,952**	**$ 410,768**	**$ (40,029)**

(concluded)

$ —	$ 162,497	$ —	$ —	$ 162,497	$ —
—	50,195	—	—	50,195	—
—	(204,236)	—	—	(204,236)	—
—	—	—	136,237	136,237	—
—	—	—	2,243	2,243	—

The notes to the financial statements are an integral part of this statement.

Statement of Fiduciary Net Assets

Fiduciary Funds and Similar Component Units

June 30, 2004
(amounts in thousands)

	Private Purpose Trust	Pension and Other Employee Benefit Trust	Investment Trust Local Agency Investment	Agency
ASSETS				
Cash and pooled investments	$ 103,426	$ 1,452,908	$ 22,013,079	$ 3,938,573
Investments, at fair value:				
Short-term	—	4,008,769	—	—
Equity securities	—	207,418,004	—	—
Debt securities	—	88,081,746	—	—
Real estate	—	18,721,922	—	—
Alternative	1,418,943	20,904,775	—	—
Securities lending collateral	—	51,763,178	—	—
Total investments	1,418,943	390,898,394	—	—
Receivables (net)	2,329	5,089,244	19,697	454,416
Due from other funds	3	350,864	—	6,163,486
Due from other governments	—	—	—	8,061
Interfund receivables	880,226	—	—	—
Loans receivable	—	—	—	32,340
Other assets	110,319	2,418,146	—	1,904
Total assets	**2,515,246**	**400,209,556**	**22,032,776**	**$ 10,598,780**
LIABILITIES				
Accounts payable	7,750	2,983,535	42	$ 4,887,551
Due to other funds	14,668	1,990	340	—
Due to other governments	—	142	81,689	4,629,036
Tax overpayments	—	—	—	1,723
Benefits payable	—	1,286,811	—	—
Deposits	110,319	—	—	574,916
Advance collections	—	—	—	20,422
Securities lending obligations	—	51,764,367	—	—
Interfund payables	—	—	—	23,431
Other liabilities	962,081	4,933,352	—	461,701
Total liabilities	**1,094,818**	**60,970,197**	**82,071**	**$ 10,598,780**
NET ASSETS				
Held in trust for pension benefits, pool participants, and other purposes	**$ 1,420,428**	**$ 339,239,359**	**$ 21,950,705**	

The notes to the financial statements are an integral part of this statement.

Statement of Changes in Fiduciary Net Assets

Fiduciary Funds and Similar Component Units

Year Ended June 30, 2004
(amounts in thousands)

	Private Purpose Trust	Pension and Other Employee Benefit Trust	Investment Trust: Local Agency Investment
ADDITIONS			
Contributions:			
Employer	$ —	$ 7,060,342	$ —
Plan member	—	5,862,998	—
Total contributions	—	12,923,340	—
Investment income:			
Net appreciation in fair value of investments	—	36,913,194	—
Interest, dividends, and other investment income	45,219	12,411,386	339,536
Less: investment expense	—	(1,970,376)	—
Net investment income	45,219	47,354,204	339,536
Receipts from depositors	366,725	—	24,098,447
Escheat income	—	—	—
Transfers in	4,226	864	—
Other	64,909	17,579	—
Total additions	**481,079**	**60,295,987**	**24,437,983**
DEDUCTIONS			
Distributions paid and payable to participants	—	14,312,709	337,913
Refunds of contributions	—	788,862	—
Administrative expense	5,144	328,063	1,623
Payments to and for depositors	88,047	317,229	23,969,881
Total deductions	**93,191**	**15,746,863**	**24,309,417**
Change in net assets	387,888	44,549,124	128,566
Net assets, July 1, 2003	**1,032,540**	**294,690,235**	**21,822,139**
Net assets, June 30, 2004	**$ 1,420,428**	**$ 339,239,359**	**$ 21,950,705**

Discretely Presented Component Units Financial Statements

Statement of Net Assets

Discretely Presented Component Units – Enterprise Activity

June 30, 2004
(amounts in thousands)

	University of California	State Compensation Insurance	California Housing Finance Agency	Nonmajor Component Units	Total
ASSETS					
Current assets:					
Cash and pooled investments	$ 160,026	$ 470,169	$ 1,593,949	$ 1,188,226	**$ 3,412,370**
Investments	6,571,792	1,451,314	2,105,081	1,584,616	**11,712,803**
Investments – restricted	—	—	—	47,113	**47,113**
Receivables (net)	1,394,549	872,515	261,887	304,314	**2,833,265**
Due from primary government	186,770	—	—	2,030	**188,800**
Due from other governments	732,375	—	—	154,676	**887,051**
Prepaid items	—	2,211	1,004	890	**4,105**
Inventories	123,577	—	—	—	**123,577**
Other current assets	99,467	648	110	56,134	**156,359**
Total current assets	9,268,556	2,796,857	3,962,031	3,337,999	**19,365,443**
Noncurrent assets:					
Restricted assets:					
Cash and pooled investments	—	—	—	29,930	**29,930**
Investments	—	—	—	13,025	**13,025**
Investments	12,005,143	12,643,137	67,128	667,024	**25,382,432**
Receivables (net)	676,784	13,500	—	149,262	**839,546**
Loans receivable	—	—	5,300,917	119,426	**5,420,343**
Deferred charges	—	38,630	35,151	1,321	**75,102**
Capital assets:					
Land	436,691	25,680	—	70,437	**532,808**
Collections – nondepreciable	231,677	—	—	4,801	**236,478**
Buildings and other depreciable property	20,422,297	361,330	1,383	1,230,561	**22,015,571**
Less: accumulated depreciation	(9,918,326)	(163,026)	(631)	(377,754)	**(10,459,737)**
Construction in progress	2,994,863	—	—	27,006	**3,021,869**
Other noncurrent assets	238,039	—	15,448	119,111	**372,598**
Total noncurrent assets	27,087,168	12,919,251	5,419,396	2,054,150	**47,479,965**
Total assets	**$ 36,355,724**	**$ 15,716,108**	**$ 9,381,427**	**$ 5,392,149**	**$ 66,845,408**

The notes to the financial statements are an integral part of this statement.

	University of California	State Compensation Insurance	California Housing Finance Agency	Nonmajor Component Units	Total
LIABILITIES					
Current liabilities:					
Accounts payable	$ 1,512,091	$ 155,133	$ 47,842	$ 108,588	**$ 1,823,654**
Due to other governments	—	—	319	141,577	**141,896**
Deposits	275,875	—	144,944	896	**421,715**
Dividends payable	—	7,200	—	—	**7,200**
Deferred revenue	602,526	—	—	59,284	**661,810**
Contracts and notes payable	—	—	—	9,454	**9,454**
Advance collections	—	298,828	—	866	**299,694**
Interest payable	—	—	117,791	715	**118,506**
Benefits payable	—	3,057,153	—	—	**3,057,153**
Securities lending obligations	3,881,107	632,716	—	—	**4,513,823**
Current portion of long-term obligations	1,294,867	—	702,586	325,811	**2,323,264**
Other current liabilities	1,284,914	221,761	307	151,270	**1,658,252**
Total current liabilities	8,851,380	4,372,791	1,013,789	798,461	**15,036,421**
Noncurrent liabilities:					
Benefits payable	—	8,766,482	—	1,483,000	**10,249,482**
Compensated absences payable	179,551	45,816	—	8,544	**233,911**
Loans payable	—	—	—	5,165	**5,165**
Certificates of participation, commercial paper, and other borrowings	294,957	—	—	9,567	**304,524**
Capital lease obligations	1,194,283	—	—	10,728	**1,205,011**
Revenue bonds payable	4,286,395	—	7,172,080	575,307	**12,033,782**
Other noncurrent liabilities	859,173	258,740	76,258	190,147	**1,384,318**
Total noncurrent liabilities	6,814,359	9,071,038	7,248,338	2,282,458	**25,416,193**
Total liabilities	**15,665,739**	**13,443,829**	**8,262,127**	**3,080,919**	**40,452,614**
NET ASSETS					
Investment in capital assets, net of related debt	7,559,999	223,984	752	458,827	**8,243,562**
Restricted:					
Nonexpendable	1,999,064	—	—	468,586	**2,467,650**
Expendable:					
Endowment	4,584,959	—	—		**4,584,959**
Education	1,404,464	—	—	398,339	**1,802,803**
Indenture	—	—	708,234		**708,234**
Employee benefits	—	—	—	272,191	**272,191**
Workers' compensation liability	—	2,048,295	—		**2,048,295**
Statute	—	—	410,314		**410,314**
Other purposes	—	—	—	160,983	**160,983**
Total expendable	5,989,423	2,048,295	1,118,548	831,513	**9,987,779**
Unrestricted	5,141,499	—	—	552,304	**5,693,803**
Total net assets	**20,689,985**	**2,272,279**	**1,119,300**	**2,311,230**	**26,392,794**
Total liabilities and net assets	**$ 36,355,724**	**$ 15,716,108**	**$ 9,381,427**	**$ 5,392,149**	**$ 66,845,408**

The notes to the financial statements are an integral part of this statement.

Statement of Revenues, Expenses, and Changes in Fund Net Assets

Discretely Presented Component Units – Enterprise Activity

Year Ended June 30, 2004
(amounts in thousands)

	University of California	State Compensation Insurance Fund	California Housing Finance Agency	Nonmajor Component Units	Total
OPERATING REVENUES					
Student tuition and fees	$ 1,377,923	$ —	$ —	$ 94,073	$ 1,471,996
Grants and contracts	3,826,641	—	39,685	461,440	4,327,766
Services and sales	5,454,519	—	11,183	3,541,781	9,007,483
Department of Energy laboratories	4,115,635	—	—	—	4,115,635
Earned premiums (net)	—	7,633,200	—	—	7,633,200
Investment and interest	—	—	346,229	9,762	355,991
Rent	—	—	—	20,913	20,913
Other	348,506	6,103	10,270	157,534	522,413
Total operating revenues	**15,123,224**	**7,639,303**	**407,367**	**4,285,503**	**27,455,397**
OPERATING EXPENSES					
Personal services	8,610,337	512,017	17,001	224,361	9,363,716
Scholarships and fellowships	334,544	—	—	28,022	362,566
Supplies	1,529,352	—	—	—	1,529,352
Services and charges	306,001	58,692	66,446	3,690,750	4,121,889
Department of Energy laboratories	4,082,089	—	—	—	4,082,089
Depreciation	899,811	18,512	142	45,503	963,968
Distributions to beneficiaries	—	6,030,554	—	—	6,030,554
Interest expense	—	—	336,052	5,224	341,276
Amortization of deferred charges	—	846,709	1,876	—	848,585
Other	2,177,835	132,166	—	644,216	2,954,217
Total operating expenses	**17,939,969**	**7,598,650**	**421,517**	**4,638,076**	**30,598,212**
Operating income (loss)	(2,816,745)	40,653	(14,150)	(352,573)	(3,142,815)
NONOPERATING REVENUES (EXPENSES)					
Primary government and federal grants	2,755,965	—	73,050	—	2,829,015
Grants provided	(390,254)	—	(73,050)	—	(463,304)
Private gifts	951,049	—	—	163,371	1,114,420
Investment and interest income	883,266	383,053	108,748	251,998	1,627,065
Interest expense and fiscal charges	(268,188)	—	—	(19,949)	(288,137)
Other	162,837	(162)	—	(75,472)	87,203
Total nonoperating revenues	**4,094,675**	**382,891**	**108,748**	**319,948**	**4,906,262**
Income (loss) before contributions	1,277,930	423,544	94,598	(32,625)	1,763,447
Capital contributions	319,852	—	—	14,928	334,780
Permanent endowments	137,079	—	—	20,013	157,092
Change in net assets	1,734,861	423,544	94,598	2,316	2,255,319
Total net assets, July 1, 2003	**18,955,124 ***	**1,848,735**	**1,024,702**	**2,308,914 ***	**24,137,475 ***
Total net assets, June 30, 2004	**$ 20,689,985**	**$ 2,272,279**	**$ 1,119,300**	**$ 2,311,230**	**$ 26,392,794**

* Restated

The notes to the financial statements are an integral part of this statement.

Notes to the Financial Statements – Index

Notes to the Financial Statements

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements present information on the financial activities of the State of California over which the Governor, the Legislature, and other elected officials have direct or indirect governing and fiscal control. These financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America (GAAP). The provisions of the following Governmental Accounting Standards Board (GASB) Statement have been implemented for the year ended June 30, 2004:

GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units, an Amendent of GASB Statement No. 14.*

In addition, the State reports capital assets, including infrastructure, in the government-wide Statement of Net Assets and reports depreciation for capital assets as part of the functions' direct expenses in the Statement of Activities. The State has been phasing in its reporting of state highway infrastructure since the 2001-02 fiscal year, as allowed by GASB Statement No. 34. These financial statements report all major infrastructure assets for the fiscal year ended June 30, 2004.

A. Reporting Entity

These financial statements present the primary government of the State and its component units. The **primary government** consists of all funds, organizations, institutions, agencies, departments, and offices that are not legally separate from the State. **Component units** are organizations that are legally separate from the State but for which the State is financially accountable, or for which the nature and significance of their relationship with the State is such that exclusion would cause the State's financial statements to be misleading or incomplete. The decision to include a potential component unit in the State's reporting entity is based on several criteria, including legal standing, fiscal dependency, and financial accountability. Following is information on the blended, fiduciary, and discretely presented component units of the State.

1. Blended Component Units

Blended components units, although legally separate entities, are in substance part of the primary government's operations. Therefore, data from these blended component units are integrated into the appropriate funds for reporting purposes.

Building authorities are blended component units because they have been created through the use of joint exercise of powers agreements with various cities to finance the construction of state buildings. The building authorities are reported as capital projects funds. As a result, the $721 million of capital lease arrangements between the building authorities and the State has been eliminated from the financial statements. Instead, only the underlying capital assets and the debt used to acquire them are reported in the government-wide financial statements. For information on how to obtain copies of the financial statements of the building authorities, contact the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250.

The *Golden State Tobacco Securitization Corporation (GSTSC)* is a not-for-profit corporation established through legislation in September 2002 solely for the purpose of purchasing Tobacco Settlement Revenues from the State. The five voting members of the State Public Works Board serve ex officio as the directors of the corporation. GSTSC is authorized to issue bonds necessary to provide sufficient funds for carrying out its purpose. GSTSC is reported in the combining statements in the Nonmajor Governmental Funds section as a special revenue fund. For information on how to obtain copies of the financial statements of GSTSC, contact the Department of Finance, Capital Outlay/Resources Section, 915 L Street, 9th Floor, Sacramento, California 94250.

The *California State University, Channel Islands Site Authority (Site Authority)* was formed in 1998 to convert the property previously known as the Camarillo State Hospital from its former use to a California State University campus and other compatible uses. The Site Authority is governed by a board of seven members comprised of four representatives of the Trustees of the California State University and three representatives from Ventura County. The *California State University, Channel Islands Financing Authority (Financing Authority)* was formed in 2000 to provide financing through revenue bonds for the construction and other improvements conducted by the Site Authority. The Site Authority and the Financing Authority are included in the California State University Programs special revenue fund in the combining statements in the Nonmajor Governmental Funds section. The loan and other transactions of $97.8 million between the two authorities have been eliminated from the financial statements. Instead, only the underlying capital assets and the debt used to acquire them are reported in the government-wide financial statements. For information on how to obtain copies of the financial statements of the Site Authority and the Financing Authority, contact the California State University, Channel Islands, One University Drive, Camarillo, California 93012.

2. Fiduciary Component Units

The State has three fiduciary component units that administer pension and other employee benefit trust funds. These entities are legally separate from the State and meet the definition of a component unit because they are fiscally dependent on the State; however, due to their fiduciary nature, they are presented in the Fiduciary Fund Statements as pension and other employee benefit trust funds, along with other primary government fiduciary funds.

The *California Public Employees' Retirement System (CalPERS)* administers pension and health benefit plans for state employees, non-teaching school employees, and employees of California public agencies. Its Board of Administration has plenary authority and fiduciary responsibility for the investment of monies and the administration of the plans. CalPERS administers the following seven pension and other employee benefit trust funds: the Public Employee's Retirement Fund, the Judges' Retirement Fund, the Judges Retirement Fund II, the Legislators' Retirement Fund, the Volunteer Firefighters' Length of Service Award Fund, the State Peace Officers' and Firefighters' Defined Contribution Plan Fund, and the Supplemental Contributions Program Fund. Copies of CalPERS' separately issued financial statements may be obtained in writing from the California Public Employees' Retirement System, Fiscal Services Division, P.O. Box 942703, Sacramento, California 94229.

The *California State Teachers' Retirement System (CalSTRS)* administers pension benefit plans for California public school teachers and certain other employees of the public school system. CalSTRS administers two pension and other employee benefit trust funds: the State Teachers' Retirement Fund and the Teachers' Health Benefits Fund. Copies of CalSTRS' separately issued financial statements may be obtained from the California State Teachers' Retirement System, P.O. Box 15275, Sacramento, California 95851.

The *University of California Retirement System (UCRS)* is part of the comprehensive benefits package that offers defined benefit plans and defined contribution plans to employees of the university. The UCRS is a fiduciary activity of the University of California, a discretely presented component unit. Copies of the University of California's separately issued financial statements may be obtained from the University of California, Financial Management, 1111 Franklin Street, 10th Floor, Oakland, California 94607.

3. Discretely Presented Component Units

Enterprise activity of discretely presented component units is reported in a separate column in the government-wide financial statements. Discretely presented component units are legally separate from the primary government and mostly provide services to entities and individuals outside the primary government. Discretely presented component units that report enterprise activity include the University of California, the State Compensation Insurance Fund, the California Housing Finance Agency, and nonmajor component units.

The *University of California* was founded in 1868 as a public, state-supported, land grant institution. It was written into the State Constitution of 1879 as a public trust to be administered by a governing board, the Regents of the University of California. The University of California is a component unit of the State because the State appoints a voting majority of the regents and because expenditures for the support of various university programs and capital outlay are appropriated by the annual Budget Act. Copies of the University of California's separately issued financial statements may be obtained from the University of California, Financial Management, 1111 Franklin Street, 10th Floor, Oakland, California 94607.

The *State Compensation Insurance Fund (SCIF)* is a self-supporting enterprise created to offer insurance protection to employers at the lowest possible cost. It operates in competition with other insurance carriers to provide services to the State, counties, cities, school districts, and other public corporations. It is a component unit of the State because the State appoints all five voting members of SCIF's governing board and has the authority to approve or modify SCIF's budget. SCIF's independent auditor issued a qualified opinion as to the fair presentation of SCIF's statutory statements and no opinion on its statements prepared in accordance with accounting principles generally accepted in the United States of America. Copies of SCIF's financial statements for the year ended December 31, 2003, may be obtained from the State Compensation Insurance Fund, 1275 Market Street, San Francisco, California 94103.

The *California Housing Finance Agency (CalHFA)* was created by the Zenovich-Moscone-Chacon Housing and Home Finance Act, as amended. CalHFA's purpose is to meet the housing needs of persons and families of low and moderate income. It is a component unit of the State because the State appoints a voting majority of CalHFA's governing board and has the authority to approve or modify its budget. Copies of CalHFA's financial statements may be obtained from the California Housing Finance Agency, P.O. Box 4034, Sacramento, California 95812.

The *California Earthquake Authority (CEA)*, a legally separate organization, offers basic earthquake insurance for California homeowners, renters, condominium owners, and mobilehome owners. The CEA is a component unit of the State because its three-member governing board consists of elected state officials and the primary government can impose its will on the CEA. However, the financial statements of the CEA have not been included in the State's financial statements because audited financial statements were not available for the year ended December 31, 2003.

State legislation created various *nonmajor component units* to provide certain services outside the primary government and to provide certain private and public entities with a low-cost source of financing for programs deemed to be in the public interest. The California Pollution Control Financing Authority, the San Joaquin River Conservancy, and the district agricultural associations are considered component units since they have a fiscal dependency on the primary government. The California Educational Facilities Authority is considered a component unit because its exclusion from the statements would be misleading because of its relationship with the primary government. California State University auxiliary organizations are considered component units because they exist entirely or almost entirely for the direct benefit of the universities. The remaining nonmajor component units are considered component units because the majority of members of their governing boards are appointed by or are members of the primary government, the primary government can impose its will on the entity, or the entity provides a specific financial benefit to the primary government. For information on how to obtain copies of the financial statements of these component units, contact the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250.

The nonmajor component units are:

The *California Alternative Energy and Advanced Transportation Financing Authority*, which provides financing for alternative energy and advanced transportation technologies;

The *California Infrastructure and Economic Development Bank*, which provides financing for business development and public improvements;

The *California Pollution Control Financing Authority*, which provides financing for pollution control facilities;

The *California Health Facilities Financing Authority*, which provides financing for the construction, equipping, and acquisition of health facilities;

The *California Educational Facilities Authority*, which issues revenue bonds to finance loans for students attending public and private colleges and universities and to assist private educational institutions of higher learning in financing the expansion and construction of educational facilities;

The *California School Finance Authority*, which provides loans to school and community college districts to assist them in obtaining equipment and facilities;

California State University auxiliary organizations, which provide services primarily to university students through foundations, associated student organizations, student unions, food service entities, book stores, and similar organizations;

District agricultural associations, which exhibit all of the industries, industrial enterprises, resources, and products of the state (the district agricultural associations' financial report is as of and for the year ended December 31, 2003);

The *Public Employees' Benefits Fund*, which is administered by the California Public Employees' Retirement System and accounts for contributions and premiums for public employee long-term care plans and for administration of a deferred compensation program;

The *San Joaquin River Conservancy*, which was created to acquire and manage public lands within the San Joaquin River Parkway;

The *California Urban Waterfront Area Restoration Financing Authority*, which provides financing for coastal and inland urban waterfront restoration projects; and

The *California Consumer Power and Conservation Financing Authority*, which provides financing for projects to increase power supplies, reduce demand for energy, and improve the efficiency and environmental performance of power plants.

4. Joint Venture

A joint venture is an entity resulting from a contractual arrangement and owned, operated, or governed by two or more participants as a separate and specific activity subject to joint control. In such an arrangement, the participants retain an ongoing financial interest or an ongoing financial responsibility in the entity. These entities are not part of the primary government or a component unit.

The State participates in a joint venture with the *Capitol Area Development Authority (CADA)*. CADA was created in 1978 by the joint exercise of powers agreement between the primary government and the City of Sacramento for the location of state buildings and other improvements. CADA is a public entity, separate from the primary government and the city, and is administered by a board of five members: two appointed by the primary government, two appointed by the city, and one appointed by the affirmative vote of at least three of the other four members of the board. The primary government designates the chairperson of the board. Although the primary government does not have an equity interest in CADA, it does have an ongoing financial interest. Based upon the appointment authority, the primary government has the ability to indirectly influence CADA to undertake special projects for the citizenry of the participants. The primary government subsidizes CADA's operations by leasing land to CADA without consideration; however, the primary government is not obligated to do so. At June 30, 2004, CADA had total assets of $16.4 million, total liabilities of $9.2 million, and total net assets of $7.2 million. Total revenues for the fiscal year were $10.03 million and expenses were $10.00 million, resulting in a net income of $24,348. Because the primary government does not have an equity interest in CADA, CADA's financial information is not included in the financial statements of this report. Separately issued financial statements may be obtained from the Capitol Area Development Authority, 1522 14th Street, Sacramento, California 95814.

5. Related Organizations

A related organization is an organization for which a primary government is accountable because that government appoints a voting majority of the organization's governing board, but which is not financially accountable to the State.

Chapter 854 of the Statutes of 1996 created an *Independent System Operator*, a state-chartered, nonprofit market institution. The Independent System Operator is responsible for providing centralized control of the statewide transmission grid to ensure the efficient use and reliable operation of the transmission system. A five-member oversight board, comprised of three Governor appointees, an appointee of the Senate Committee on Rules, and an appointee of the Speaker of the Assembly, oversees the Independent System Operator and appoints a governing board that is broadly representative of the state's electricity users and providers. The State's accountability for this institution does not extend beyond making the appointments. Because the primary government is not financially accountable for the Independent System Operator, the financial information of this institution is not included in the financial statements of this report. For information on how to obtain copies of the financial statements of the Independent System Operator, contact the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, CA 94250.

The *Bay Area Toll Authority*, which is not part of the State's reporting entity, was created by the California Legislature in 1997 to administer the base $2 toll on toll revenues collected from the San Francisco Bay Area's seven state-owned toll bridges and to have program oversight related to certain bridge construction projects. Additional information on the Bay Area Toll Authority may be obtained from the Metropolitan Transportation Commission, 101 Eighth Street, Oakland, California 94607.

B. Government-wide and Fund Financial Statements

Government-wide financial statements (the Statement of Net Assets and the Statement of Activities) report information on all the nonfiduciary activities of the primary government and its component units. The primary government is reported separately from legally separate component units for which the State is financially accountable. Within the primary government, the State's governmental activities, which are normally supported by taxes and intergovernmental revenues, are reported separately from business-type activities, which rely to a significant extent on fees and charges for support. The effect of interfund activity has been removed from the statements, with the exception of amounts between governmental and business-type activities, which are presented as internal balances and transfers. Centralized services provided by the General Fund for other funds are charged as direct costs to the funds that received those services. Also, the General Fund recovers from the federal government the cost of centralized services provided to federal programs.

The Statement of Net Assets reports all of the financial and capital resources of the government as a whole in a format where assets equal liabilities plus net assets. The statement of activities demonstrates the degree to which the expenses of a given function are offset by program revenues. Program revenues include charges to customers who purchase, use, or directly benefit from goods, services, or privileges provided by a given function. Program revenues also include grants and contributions that are restricted to meeting the operational or capital requirements of a particular function. Taxes and other items that are not program-related are reported as general revenues.

Fund financial statements are provided for governmental funds, proprietary funds, fiduciary funds and similar component units, and discretely presented component units. A fund is a fiscal and accounting entity with a self-balancing set of accounts. Fund accounting segregates funds according to their intended purpose and is used to aid management in demonstrating compliance with finance-related legal and contractual provisions. The minimum number of funds is maintained that is consistent with legal and managerial requirements. Fiduciary funds, although excluded from the government-wide statements, are included in the fund financial statements. Major governmental and enterprise funds are reported in separate columns in the fund financial statements. Nonmajor governmental and proprietary funds are grouped into separate columns. Discretely presented component unit statements, which follow the fiduciary fund statements, also separately report the enterprise activity of the major discretely presented component units. The enterprise activity of nonmajor discretely presented component units is grouped in a separate column.

Governmental fund types are used primarily to account for services provided to the general public without charging directly for those services.

The State reports the following major governmental funds.

The *General Fund* is the main operating fund of the State. It accounts for transactions related to resources obtained and used for those services that do not need to be accounted for in another fund.

The *Federal Fund* accounts for the receipt and use of grants, entitlements, and shared revenues received from the federal government.

The *Transportation Construction Fund* accounts for gasoline taxes, bond proceeds, and other revenues that are used for highway and passenger rail construction.

Proprietary fund types focus on the determination of operating income, changes in net assets, financial position, and cash flows.

Proprietary funds distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. Operating expenses include the cost of sales and services, administrative expenses, and depreciation on capital assets. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

For its proprietary funds, the State applies all applicable GASB pronouncements. In addition, the State applies all applicable Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board (APB) Opinions, and Committee on Accounting Procedure (CAP) Accounting Research Bulletins issued on or before November 30, 1989, unless these pronouncements conflict with or contradict GASB pronouncements. The State has elected not to apply FASB pronouncements issued after November 30, 1989, for its enterprise funds.

The State has two proprietary fund types: enterprise funds and internal service funds.

Enterprise funds record business-type activity for which a fee is charged to external users for goods and services. In addition, the State is required to report activities as enterprise funds in the context of the activity's principal revenue sources when any of the following criteria are met:

1. The activity's debt is secured solely by fees and charges of the activity;
2. There is a legal requirement to recover costs; or
3. The pricing policies of fees and charges are designed to recover costs.

The State reports the following *major enterprise funds*.

The *Electric Power Fund* accounts for the acquisition and resale of electric power to retail end-use customers.

The *Water Resources Fund* accounts for charges to local water districts and the sale of excess power to public utilities.

The *Public Building Construction Fund* accounts for rental charges from the lease of public assets.

The *State Lottery Fund* accounts for the sale of California State Lottery (Lottery) tickets and the Lottery's payments for education.

The *Unemployment Programs Fund* accounts for employer and worker contributions used for payments of unemployment insurance and disability benefits.

*Nonmajor enterprise fund*s account for additional operations that are financed and operated in a manner similar to private business enterprises.

Additionally, the State reports *internal service funds* as a proprietary fund type with governmental activity. Internal service funds account for goods or services provided to other agencies, departments, or governments on a cost-reimbursement basis. The goods and services provided include: architectural services, construction and improvements, printing and procurement services, goods produced by inmates of state prisons, data processing services, administrative services related to water delivery, and equipment used by the California Department of Transportation. Internal service funds are included in the governmental activities at the government-wide level.

Fiduciary fund types are used to account for assets held by the State. The State acts as a trustee or as an agent for individuals, private organizations, other governments, or other funds. Fiduciary funds, including fiduciary component units, are not included in the government-wide financial statements.

The State has the following four fiduciary fund types.

Private purpose trust funds account for all trust arrangements, other than those properly reported in pension or investment trust funds, whereby principal and income benefit individuals, private organizations, or other governments.

Pension and other employee benefit trust funds of the primary government and fiduciary component units account for transactions, assets, liabilities, and net assets available for plan benefits of the retirement systems and for other employee benefit programs.

An *investment trust fund* accounts for the deposits, withdrawals, and earnings of the Local Agency Investment Fund, an external investment pool for local governments and public agencies.

Agency funds account for assets held by the State, which acts as an agent for individuals, private organizations, or other governments.

Discretely presented component units consist of certain organizations that have enterprise activity. The enterprise activity component units are the University of California, the State Compensation Insurance Fund, the California Housing Finance Agency, and nonmajor component units. All of the enterprise activity of the discretely presented component units is reported in a separate column in the government-wide financial statements and on separate pages following the fund financial statements.

C. Measurement Focus and Basis of Accounting

1. Government-wide Financial Statements

The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Grants and similar transactions are recognized as revenue as soon as all eligibility requirements imposed by the provider have been met.

2. Fund Financial Statements

The measurement focus and basis of accounting for the fund financial statements vary with the type of fund. **Governmental fund types** are presented using the current financial resources measurement focus. With this measurement focus, operating statements present increases and decreases in net current assets; the unreserved fund balance is a measure of available spendable resources.

The accounts of the governmental fund types are reported using the modified accrual basis of accounting. Under the modified accrual basis, revenues are recorded as they become measurable and available, and expenditures are recorded at the time the liabilities are incurred. Principal tax revenues susceptible to accrual are recorded as taxpayers earn income (personal income and corporation taxes), as sales are made (consumption and use taxes), and as the taxable event occurs (miscellaneous taxes), net of estimated tax overpayments. Other revenue sources are recorded when they are earned or when they are due, provided they are measurable and available within the ensuing 12 months.

Agency funds are custodial in nature and do not measure the results of operations. Assets and liabilities are recorded using the modified accrual basis of accounting.

Proprietary fund types, the **investment trust fund, private purpose trust funds,** and **pension and other employee benefit trust funds** are accounted for using the economic resources measurement focus.

The accounts of the proprietary fund types, the investment trust fund, private purpose trust funds, and pension and other employee benefit trust funds are reported using the accrual basis of accounting. Under the accrual basis, most transactions are recorded when they occur, regardless of when cash is received or disbursed.

Lottery revenue and the related prize expenses are recognized when sales are made. Certain prizes are payable in deferred installments. Such liabilities are recorded at the present value of amounts payable in the future.

For purposes of the Statement of Cash Flows, all cash and pooled investments in the State Treasurer's pooled investment program are considered to be cash and cash equivalents.

Discretely presented component units are accounted for using the economic resources measurement focus and the accrual basis of accounting.

D. Inventories

Inventories of supplies are reported at cost and inventories held for resale are stated at the lower of average cost or market. In the government-wide financial statements, inventories for both governmental and business-type activities are expensed when consumed and unused inventories are reported as an asset on the Statement of Net Assets. In the fund financial statements, governmental funds report inventories as expenditures when purchased, and proprietary funds report inventories as expenditure when consumed.

The discretely presented component units have inventory policies similar to those of the primary government.

E. Deposits and Investments

The State reports investments at fair value, as prescribed by GAAP. Additional information on the State's investments can be found in Note 3, Deposits and Investments.

F. Net Investment in Direct Financing Leases

The State Public Works Board, an agency that accounts for its activities as an enterprise fund, has entered into lease-purchase agreements with various other primary government agencies, the University of California, and certain local agencies. The payments from these leases are used to satisfy the principal and interest requirements of revenue bonds issued by the State Public Works Board to finance the cost of projects such as acquisition and construction of facilities and equipment. Upon expiration of these leases, jurisdiction of the facilities and projects transfers to the primary government agency, the University of California, or the local agency. The State Public Works Board records the net investment in direct financing leases at the net present value of the minimum lease payments.

G. Deferred Charges

The deferred charges account primarily represents operating and maintenance costs and unrecovered capital costs in the enterprise fund type that will be recognized as expenses over the remaining life of long-term state water supply contracts in the Water Resources Fund. These costs are billable in future years. In addition, the account includes unbilled interest earnings on unrecovered capital costs that are recorded as deferred charges. These charges are recognized when billed in future years under the terms of water supply contracts. The deferred charges for the Public Buildings Construction Fund include bond counsel fees, trustee fees, rating agency fees, underwriting costs, insurance costs, and miscellaneous expenses. Bond issuance costs are amortized using the straight-line method over the term of the bonds. Amortization of bond issue costs during the facility construction period is capitalized and included in the construction costs. Deferred charges are also included in the State Lottery Fund and nonmajor enterprise funds. Bond discounts and issuance costs recorded as expenditures in certain capital projects and special revenue funds are reclassified as deferred charges in the governmental activities column of the Statement of Net Assets.

H. Capital Assets

Capital assets are categorized into land, state highway infrastructure, collections, buildings and other depreciable property, and construction in progress. The buildings and other depreciable property account includes buildings, improvements other than buildings, equipment, personal property, intangible assets, certain infrastructure assets, certain books, and other capitalized and depreciable property. The value of the capital assets, including the related accumulated depreciation, is reported in the applicable governmental, business-type, or component unit activities columns in the government-wide Statement of Net Assets.

The primary government has a large collection of historical and contemporary treasures that have important documentary and artistic value. These assets are not capitalized or depreciated, because they are cultural resources and cannot reasonably be valued and/or the assets have inexhaustible useful lives. These treasures and works of art consist of furnishings, portraits and other paintings, books, statues, photographs, and miscellaneous artifacts. These collections meet the conditions for exemption from capitalization because the collections are: held for public exhibition, education, or research in furtherance of public service, rather than financial gain; protected, kept unencumbered, cared for, and preserved; and are subject to an organizational policy that requires the proceeds from sales of collection items to be used to acquire other items for collections.

In general, capital assets of the primary government are defined as assets that have a normal useful life of at least one year and a unit acquisition cost of at least $5,000. These assets are recorded at historical cost or estimated historical cost, including all costs related to the acquisition. Donated capital assets are recorded at the fair market value on the date the gift was received. Major capital asset outlays are capitalized as projects are constructed.

Buildings and other depreciable property are depreciated using the straight-line method with no salvage value for governmental activities. Buildings and other improvements are depreciated over 40 years. Equipment and personal property are depreciated over 5 years. Buildings and other depreciable property used by the

California State University are depreciated from 3 to 45 years. Depreciable assets of business-type activities are depreciated using the straight-line method over their estimated useful or service lives, ranging from 2 to 100 years.

California has elected to use the modified approach for capitalizing the infrastructure assets of the state highway system. The state highway system consists of over 49,000 lane-miles and over 12,000 bridges that are maintained by the California Department of Transportation. By using the modified approach, the infrastructure assets of the state highway system are not depreciated and all expenditures made for those assets, except for additions and improvements, are expensed in the period incurred. All additions and improvements made after June 30, 2001, are capitalized. All infrastructure assets that are related to projects completed prior to July 1, 2001, are recorded at the historical costs contained in annual reports of the American Association of State Highway and Transportation Officials (AASHTO) and the Federal Highway Administration.

The capital assets of the discretely presented component units are reported at cost at the date of acquisition, or at fair market value at the date of donation in the case of gifts. They are depreciated over their estimated useful service lives.

I. Long-term Obligations

Long-term obligations consist of certain unmatured general obligation bonds, certain unmatured revenue bonds, capital lease obligations, certificates of participation, commercial paper, the net pension obligation of the pension and other employee benefit trust funds, the liability for employees' compensated absences and workers' compensation claims, amounts owed for lawsuits, reimbursement for costs mandated by the State, the outstanding Proposition 98 funding guarantee owed to schools, the liability for Lottery prizes and annuities, and the primary government's share of the University of California pension liability that is due in more than one year. In the government-wide financial statements, current and noncurrent obligations are reported as liabilities in the applicable governmental activities, business-type activities, and component units columns of the Statement of Net Assets.

Bond premiums and discounts, as well as issuance costs, for business-type activities and component units are generally deferred and amortized over the life of the bonds. In these instances, bonds payable are reported net of the applicable premium or discount and bond issuance costs are reported as deferred charges. Bond premiums and discounts, as well as issuance costs, for governmental activities are expensed in the year incurred in the fund financial statements. These costs are reported as deferred charges in the government-wide financial statements.

With approval in advance from the Legislature, certain authorities and state agencies may issue revenue bonds. Principal and interest on revenue bonds are payable from the pledged revenues of the respective funds, building authorities, and agencies. The General Fund has no legal liability for payment of principal and interest on revenue bonds. With the exception of certain special revenue funds (Transportation Construction, California State University Programs, and the Golden State Tobacco Securitization Corporation) and the building authorities' capital projects funds, the liability for revenue bonds is recorded in the respective fund.

J. Compensated Absences

The government-wide financial statements report both the current and the noncurrent liabilities for compensated absences, which are vested unpaid vacation and annual leave. However, unused sick-leave balances are not included in the compensated absences because they do not vest to employees. In the fund financial statements for governmental funds, no liabilities are accrued, because it is anticipated that compensated absences will not be used in excess of a normal year's accumulation. The amounts of vested unpaid vacation and annual leave accumulated by state employees are accrued in proprietary funds when incurred. In the discretely presented component units, the compensated absences are accounted for as in the proprietary funds of the primary government.

K. Net Assets and Fund Balance

The difference between fund assets and liabilities is called "net assets" on the government-wide financial statements, the proprietary and fiduciary fund statements, and the component unit statements; it is called "fund balance" on the governmental fund statements. The government-wide financial statements have the following categories of net assets.

Investment in capital assets, net of related debt, represents capital assets, net of accumulated depreciation, reduced by the outstanding principal balances of debt attributable to the acquisition, construction, or improvement of those assets.

Restricted net assets result from transactions with purpose restrictions and are designated as either *nonexpendable* or *expendable*. *Nonexpendable restricted net assets* are subject to externally imposed restrictions that must be retained in perpetuity. *Expendable restricted net assets* are subject to externally imposed restrictions that can be fulfilled by actions of the State.

Unrestricted net assets are neither restricted nor invested in capital assets, net of related debt.

In the fund financial statements, proprietary funds have similar categories of net assets. Governmental funds have two sections: *reserved and unreserved*. Part or all of the total fund balance may be reserved as a result of law or generally accepted accounting principles. Reserves represent those portions of the fund balances that are segregated for specific uses. The reserves of the fund balance for governmental funds are as follows.

Reserved for encumbrances represents goods and services that are ordered, but not received, by the end of the fiscal year.

Reserved for interfund receivables represents advances to other funds that do not represent expendable available financial resources.

Reserved for loans receivable represents the noncurrent portion of loans receivable that does not represent expendable available financial resources.

*Reserved for continuing appropriation*s represents the unencumbered balance of all appropriations for which the period of availability extends beyond the period covered in the report. These appropriations are legally segregated for a specific future use.

The *unreserved* amounts represent the net of total fund balance, less reserves for governmental funds.

Fiduciary fund net assets are "amounts held in trust for benefits and other purposes."

L. Restatement of Beginning Fund Balances and Net Assets

1. Fund Financial Statements

The beginning fund balance of the **nonmajor governmental funds** was increased by a total of $103 million as a result of prior-period adjustments to correct errors, such as a $96 million overstatement of liabilities for the California State University programs.

The beginning net assets of the **internal service funds** were decreased by $2 million as a result of a prior-period adjustment for the impaired equipment loss caused by the closure of a Prison Industries' facility.

The beginning net assets of the **enterprise funds** were decreased by a net total of $152 million. The decrease is primarily the result of the reclassification of the Public Employees' Benefits Fund from an enterprise fund activity to a discretely presented component unit activity. However, the resulting $192 million decrease was reduced by the addition of $40 million in previously unreported capital assets that were added to the California State University's enterprise activities.

Beginning net assets of the **discretely presented component units – enterprise activity** were increased by a total of $3.9 billion. Of the total increase, $3.7 billion was the result of reporting additional component units through the implementation of GASB Statement No. 39. The amounts reported for the University of California now include the activity of its foundations, and California State University auxiliary organizations were added as a discretely presented component unit. The remaining increase, $192 million, resulted from the reclassification of the Public Employees' Benefits Fund from an enterprise fund to a discretely presented component unit.

2. Government-wide Financial Statements

The beginning net assets of the **governmental activities** were increased by $63.9 billion as a result of the retroactive reporting of the estimated historical cost of the state highway infrastructure assets.

The beginning net assets of the **business-type activities** and the **component units** were restated as described in the previous section for enterprise funds and discretely presented component units – enterprise activity, respectively.

M. Guaranty Deposits

The State is custodian of guaranty deposits held to protect consumers, to secure the State's deposits in financial institutions, and to ensure payment of taxes and fulfillment of obligations to the State. Guaranty deposits of securities and other properties are not shown on the financial statements.

NOTE 2: BUDGETARY AND LEGAL COMPLIANCE

A. Budgeting and Budgetary Control

The State's annual budget is prepared primarily on a modified accrual basis for governmental funds. The Governor recommends a budget for approval by the Legislature each year. This recommended budget includes estimated revenues; however, revenues are not included in the annual budget bill adopted by the Legislature. Under state law, the State cannot adopt a spending plan that exceeds estimated revenues.

Under the State Constitution, money may be drawn from the treasury only through a legal appropriation. The appropriations contained in the Budget Act, as approved by the Legislature and signed by the Governor, are the primary sources of annual expenditure authorizations and establish the legal level of control at the appropriation level for the annual operating budget. The budget can be amended throughout the year by special legislative action, budget revisions by the Department of Finance, or executive orders of the Governor.

Amendments to the original budget for the year ended June 30, 2004, were legally made, and they had the effect of decreasing spending authority and expenditures for the year.

Appropriations are generally available for expenditure or encumbrance either in the year appropriated or for a period of three years if the legislation does not specify a period of availability. At the end of the availability period, the encumbering authority for the unencumbered balance lapses. Some appropriations continue indefinitely, while others are available until fully spent. Generally, encumbrances must be liquidated within two years from the end of the period when the appropriation is available. If the encumbrances are not liquidated within this additional two-year period, the spending authority for these encumbrances lapses.

B. Legal Compliance

State agencies are responsible for exercising basic budgetary control and ensuring that appropriations are not overspent. The State Controller's Office is responsible for overall appropriation control and does not allow expenditures in excess of authorized appropriations.

Financial activities are mainly controlled at the appropriation level but can vary, depending on the presentation and wording contained in the Budget Act. Certain items that are established at the category, program, component, or element level can be adjusted by the Department of Finance. For example, an appropriation for support may have detail accounts for personnel services, operating expenses and equipment, and reimbursements. The Department of Finance can authorize adjustments between the detail accounts but cannot increase the amount of the overall support appropriation. While the financial activities are controlled at various levels, the legal level of budgetary control, or the extent to which management may amend the budget without seeking approval of the governing body, has been established in the Budget Act at the appropriation level for the annual operating budget.

NOTE 3: DEPOSITS AND INVESTMENTS

The State reports investments at fair value. State statutes authorize investments in certain types of securities. The State Treasurer administers a single pooled investment program comprising both an internal investment pool and an external investment pool (the Local Agency Investment Fund). There is a single portfolio of investments, with all participants having an undivided interest in the portfolio. Both pools are administered in the same manner, as described below. In addition, certain funds have the authority to separately invest their cash.

A. State Treasurer's Pooled Investment Program

The State's pooled investment program and certain funds of the primary government are allowed by state statutes, bond resolutions, and investment policy resolutions to have investments in United States government securities, negotiable certificates of deposit, bankers' acceptances, commercial paper, corporate bonds, bank notes, mortgage loans and notes, other debt securities, repurchase agreements, reverse repurchase agreements, equity securities, real estate, mutual funds, and other investments.

The State Treasurer's Office administers a pooled investment program for the primary government and for certain discretely presented component units. As of June 30, 2004, the discretely presented component units' cash and pooled investments were approximately 7.1% of the State Treasurer's pooled investment portfolio. This program enables the State Treasurer's Office to combine available cash from all funds and to invest cash that exceeds current needs.

Both deposits and investments are included in the State's investment program. The State Treasurer's Office maintains cash deposits with certain banks where the income earned on the deposits compensates the banks for services and uncleared checks that are deposited in the pooled investment program's accounts.

All demand and time deposits held by financial institutions as of June 30, 2004, totaling approximately $7.1 billion, were insured by federal depository insurance or by collateral held by the State Treasurer's Office or an agent of the State Treasurer's Office in the State's name. The California Government Code requires collateral pledged for demand and time deposits to be deposited with the State Treasurer.

As of June 30, 2004, the State Treasurer's Office had amounts on deposit with a fiscal agent totaling $31 million related to principal and interest payments to bondholders. Additionally, there was $36 million in a compensating balance account with a custodial agent, which was designed to provide sufficient earnings to cover fees for custodial services. Most of these deposits are insured by federal depository insurance or by collateral held by an agent of the State Treasurer's Office in the State's name.

The State Treasurer's Office reports its investments at fair value. The fair value of all securities in the State Treasurer's pooled investment program is based on quoted market prices. As of June 30, 2004, the average remaining life of the securities in the pooled investment program administered by the State Treasurer's Office was approximately 209 days.

The Pooled Money Investment Board provides regulatory oversight over the State Treasurer's pooled investment program. The purpose of the board is to design an effective cash management and investment program, using all monies flowing through the State Treasurer's Office bank accounts and keeping all available funds invested in a manner consistent with the goals of safety, liquidity, and yield. The Pooled Money Investment Board is comprised of the State Treasurer as chair, the State Controller, and the Director of Finance. This board designates the amounts of temporarily idle money available for investment. The State Treasurer is charged with making the actual investment transactions for this program. This investment program is not registered with the Securities and Exchange Commission as an investment company.

The value of the deposits in the State Treasurer's pooled investment program, including the Local Agency Investment Fund, is equal to the dollars deposited in the program. The fair value of the position in the program may be greater or less than the value of the deposits, with the difference representing the unrealized gain or loss. As of June 30, 2004, this difference was immaterial to the valuation of the program. The pool is run with "dollar-in, dollar-out" participation. There are no share-value adjustments to reflect changes in fair value.

Certain funds have elected to participate in the pooled investment program, even though they have the authority to make their own investments. Others may be required by legislation to participate in the program. As a result, the deposits of these funds or accounts may be considered involuntary. However, these funds or accounts are part of the State's reporting entity. The remaining participation in the pool, the Local Agency Investment Fund, is voluntary.

Certain funds that have deposits in the State Treasurer's pooled investment program do not receive the interest earnings on their deposits. Instead, the earnings are legally required to be assigned to the State's General Fund. Most of the $123 million in interest revenue received by the General Fund from the pooled investment program in the 2003-04 fiscal year was earned on balances in these funds.

The State Treasurer's pooled investment program values participants' shares on an amortized cost basis. Specifically, the program distributes income to participants quarterly, based on their relative participation during the quarter. This participation is calculated based on (1) realized investment gains and losses calculated on an amortized cost basis, (2) interest income based on stated rates (both paid and accrued), (3) amortization of discounts and premiums on a straight-line basis, and (4) investment and administrative expenses. This method differs from the fair value method used to value investments in these financial statements, because the amortized cost method is not designed to distribute to participants all unrealized gains and losses in the fair value of the pool's investments. Because the total difference between the fair value of the investments in the pool and the value distributed to pool participants using the amortized cost method described above is not material, no adjustment was made to the financial statements.

The State Treasurer's Office also reports participant fair value as a ratio of amortized cost on a quarterly basis. The State Treasurer's Office has not provided or obtained a legally binding guarantee to support the principal invested in the investment program.

The fair value and the ranges of interest rates and maturity dates of each major investment classification in the State Treasurer's pooled investment program are summarized in Table 1, which follows.

As of June 30, 2004, asset-backed securities comprised slightly more than 1.6% of the pooled investments. There were no floating-rate notes held at year-end. For floating-rate notes held in the portfolio during the fiscal year, the interest received by the State Treasurer's pooled investment program rose or fell as the underlying index rate rose or fell. The structure of the floating-rate notes in the State Treasurer's pooled investment program portfolio was such that it hedged the portfolio against the risk of increasing interest rates. A significant portion of the asset-backed securities consists of mortgage-backed securities, which are called real estate mortgage investment conduits (REMICs). A REMIC is a security backed by a pool of mortgages. The REMICs in the State's portfolio have a fixed principal payment schedule.

The California Government Code allows the State Treasurer's Office to enter into repurchase agreements as part of its pooled investment program. A repurchase agreement consists of two simultaneous transactions. One is the purchase of securities by the State Treasurer's Office from a bank or dealer. The other is a commitment by the bank or dealer to repurchase the securities from the State Treasurer's Office at the same price, plus interest, at a mutually agreed-upon date. As the investor, the State is protected by underlying specific government securities, which are pledged as collateral during the length of the investment. During the year ended June 30, 2004, the State Treasurer's Office entered into 28 repurchase agreements, with a carrying value of approximately $4.7 billion. As of June 30, 2004, the State Treasurer's Office did not have any repurchase agreements outstanding.

The California Government Code allows the State Treasurer's Office to enter into reverse repurchase agreements as part of its pooled investment program. A reverse repurchase agreement is a sale of securities with a simultaneous agreement to repurchase them in the future at the same price plus a contract rate of interest. The fair value of the securities underlying reverse repurchase agreements normally exceeds the cash received, providing the dealers a margin against a decline in the fair value of the securities. If the dealers defaulted on their obligations to resell these securities to the State Treasurer's Office or to provide securities or cash of equal value, the State Treasurer's pooled investment program would suffer an economic loss equal to the difference between the fair value plus the accrued interest of the underlying securities and the agreement obligation, including accrued interest. During the year ended June 30, 2004, the State Treasurer's Office entered into six reverse repurchase agreements by temporarily selling investments with a carrying value of approximately $1.0 billion. The maturities of investments made with the proceeds from reverse repurchase agreements are matched to the maturities of the agreements. As of June 30, 2004, the State Treasurer's Office did not have any reverse repurchase agreements outstanding.

B. Other Investment Programs

Enterprise funds, special revenue funds, fiduciary funds, and a building authority in the capital projects funds of the primary government also make separate investments, which are presented at fair value. The fiduciary funds include pension and other employee benefit trust funds of the following fiduciary component units: the California Public Employees' Retirement System (CalPERS), the California State Teachers' Retirement System (CalSTRS), and the University of California Retirement System (UCRS). CalPERS, CalSTRS, and UCRS account for $385.6 billion (97%) of these separately invested funds.

CalPERS and CalSTRS exercise their authority under the State Constitution to invest in stocks, bonds, mortgages, real estate, and other investments.

The fair value of CalPERS' investments in securities is generally based on published market prices and quotations from major investment firms. Many factors are considered in arriving at fair value. In general, however, corporate bonds are valued based on yields currently available on comparable securities of issuers with similar credit ratings. Investments in certain restricted common stocks are valued at the quoted market price of the issuer's unrestricted common stock, less an appropriate discount.

CalPERS' mortgages are valued on the basis of their future principal and interest payments, discounted at prevailing interest rates for similar instruments. The fair value of real estate investments, principally rental property subject to long-term net leases, is estimated based on independent appraisals. Short-term investments are reported at market value, when available, or at cost plus accrued interest, which approximates market value when market value is not available. For investments where no readily ascertainable market value exists, management, in consultation with its investment advisors, has determined the fair values for the individual investments.

Under the State Constitution and statutory provisions governing CalPERS' investment authority, CalPERS, through its outside investment managers, holds investments in futures and options and enters into forward foreign currency exchange contracts. Futures and options with a negative fair value of approximately $89 million were held for investment purposes as of June 30, 2004. Gains and losses on futures and options are determined based upon quoted market values and recorded in the statement of changes in fiduciary net assets.

Due to the level of risk associated with certain derivative investment securities, it is reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the financial statements.

Forward foreign currency exchange contracts are used primarily to hedge against changes in exchange rates related to foreign securities. As of June 30, 2004, CalPERS had approximately a negative $89 million net exposure to loss from forward foreign currency exchange transactions related to the approximately

$38.0 billion international debt and equity portfolios. CalPERS could be exposed to risk if the counterparties to the contracts are unable to meet the terms of the contracts. CalPERS investment managers seek to control this risk through counterparty credit evaluations and approvals, counterparty credit limits, and exposure monitoring procedures. CalPERS anticipates that the counterparties will be able to satisfy their obligations under the contracts.

The fair value of investments for CalSTRS is generally based on published market prices and quotations from major investment firms. In the case of debt securities acquired through private placements, management computes fair value based on market yields and average maturity dates of comparable quoted securities. Mortgages are valued based on future principal and interest payments, and are discounted at prevailing interest rates for similar instruments. Real estate equity investment fair values are based on either recent estimates provided by CalSTRS' contract real estate advisors or independent appraisers. Short-term investments are reported at cost or amortized cost, which approximates fair value. Alternative investments represent interests in private equity partnerships which the system enters into under a limited partnership agreement. For alternative investments and other investments where no readily ascertainable market value exists, CalSTRS management, in consultation with its investment advisors, has determined the fair value for the individual investments. Purchases and sales are recorded on the trade date.

The State Constitution, state statutes, and board policies permit CalPERS and CalSTRS to lend their securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. Third-party securities lending agents are under contract to lend domestic and international equity and debt securities. All securities loans can be terminated on demand by the lender or the borrower. Collateral, in the form of cash or other securities, is required at 102% and 105% of the fair value of domestic and international securities loaned, respectively, for both CalPERS and CalSTRS. As of June 30, 2004, there was no credit risk of exposure to borrowers, because the amount of collateral held exceeded the amounts owed by the borrowers. Collateral securities received are not permitted to be pledged or sold unless the borrower defaults. The contracts with the securities lending agents require them to indemnify CalPERS and CalSTRS if the borrowers fail to return the securities (and if the collateral is not sufficient to replace the securities loaned) or if the borrowers fail to pay for income distributions by the securities' issuers while the securities are on loan.

For CalPERS, the average terms of the overall loans managed by its five securities lending agents were 45 days, 34 days, 45 days, 92 days, and 22 days, respectively. In accordance with CalPERS investment guidelines, the cash collateral was invested in short-term investment funds that, at June 30, 2004, had weighted average maturities of 362 days, 102 days, 156 days, and 296 days, respectively, for four of the five portfolios. For one portfolio, a weighted average maturity was not applicable.

For CalSTRS, cash collateral received on each security loan was invested in short-term investments that, at June 30, 2004, had a weighted average maturity of 29 days.

The Regents of the University of California (regents), as the governing board, are responsible for the management of the university's and the UCRS's investments and establishes investment policy. For more information about the investment policies of the University of California, refer to section C, Discretely Presented Component Units, below.

As of June 30, 2004, the State, including discretely presented component units, had investments in securities lending agreements, real estate, investment contracts, mutual funds, and other investments that totaled

$100.5 billion. These investments are not subject to classification. All remaining investments reported as of June 30, 2004, are categorized in three credit risk categories:

1. Insured or registered, or securities held by the State or its agent in the State's name;

2. Uninsured and unregistered, with securities held by the counterparty's trust department or by an agent in the State's name; and

3. Uninsured and unregistered, with securities held by the counterparty, its trust department, or an agent, but not in the State's name.

The types of investments reported at year-end are representative of the types of investments made during the year. Furthermore, the credit risk associated with the investments reported at year-end is representative of the credit risk associated with investments made during the year.

Table 1 presents the primary government's investments by credit risk category.

Table 1

Schedule of Investments – Primary Government
June 30, 2004
(amounts in thousands)

	Interest Rates*	Maturity	Credit Risk Category 1	2	3	Total Fair Value**
Pooled investments* **						
U.S. government securities	0.95 – 3.31	1 day – 5 years	$ 23,492,502	$ —	$ —	$ 23,492,502
Negotiable certificates of deposit	1.05 – 1.76	1 day – 1 year	9,279,115	—	—	9,279,115
Commercial paper	1.00 – 1.39	1 day – 180 days	11,140,253	—	—	11,140,253
Corporate bonds	1.73 – 2.94	1 day – 3 years	1,623,969	—	—	1,623,969
Bank notes	1.05 – 1.76	1 day – 1 year	1,224,249	—	—	1,224,249
Total pooled investments			**46,760,088**	**—**	**—**	**46,760,088**
Separately invested funds subject to categorization						
Equity securities			181,787,583	3,075	—	181,790,658
Securities lending collateral			51,648,240	—	—	51,648,240
Mortgage loans and notes			30,871,935	37,380	—	30,909,315
U.S. government and agencies			16,370,948	346,961	—	16,717,909
Commercial paper			2,178,361	—	—	2,178,361
Corporate bonds			12,881,774	126,301	—	13,008,075
Other investments			6,308,305	30,013	—	6,338,318
Total separately invested funds subject to categorization			**302,047,146**	**543,730**	**—**	**302,590,876**
Separately invested funds not subject to categorization						
Investments held by broker-dealers under securities loans with cash collateral						50,955,156
Real estate						18,721,741
Venture capital and private equity funds						618,041
Investment contracts						2,751,707
Mutual funds						5,080,899
Insurance contracts						443,271
Mortgage loans						293,527
Other investments						14,626,070
Total separately invested funds not subject to categorization						**93,490,412**
Total investments			**$ 348,807,234**	**$ 543,730**	**$ —**	**442,841,376**
Fiduciary fund investments						
Less: investment trust fund						22,013,079
Less: private purpose trust funds						1,418,943
Less: pension and other employee benefit trust funds						390,898,394
Total government-wide investments						**28,510,960**
Less: current government-wide investments						26,133,646
Total noncurrent government-wide investments						**$ 2,377,314**

* These interest rates represent high and low monthly averages for each investment type during the year.

** Investments are reported at fair value except for $182 million for investment contracts that are reported at cost in two enterprise funds.

*** Approximately 7.1% of the pooled investments are investments of discretely presented component units. For separately invested funds of discretely presented component units, see Table 2.

C. Discretely Presented Component Units

A portion of the cash and pooled investments of the State Compensation Insurance Fund (SCIF), the California Housing Finance Agency (CalHFA), and nonmajor component units is invested in the State Treasurer's pooled investment program. Additionally, state law, bond resolutions, and investment policy resolutions allow these component units to invest in U.S. government securities, state and municipal securities, commercial paper, corporate bonds, investment agreements, real estate, and other investments.

The investments of the University of California, a discretely presented component unit, and the UCRS, a pension and other employee benefit trust fund reported in the Fiduciary Fund statements of the primary government, are primarily stated at fair value. Investments authorized by the regents include equity securities, fixed-income securities, and real estate. The equity portion of the investment portfolio may include domestic and foreign common and preferred stocks, and actively managed and passive (index) strategies, along with a modest exposure to private equities. Private equities include venture capital partnerships, buy-outs, and international funds. The fixed-income portion of the investment portfolio may include both domestic and foreign securities, along with certain securitized investments, including mortgage-backed and asset-backed securities. Absolute return strategies, incorporating short sales, plus derivative or option positions to implement or hedge an investment position, are also authorized. Where donor agreements place constraints on allowable investments, assets associated with endowments are invested in accordance with the terms of the agreements.

The University of California participates in a securities lending program as a means to augment income. The university loans securities to select brokerage firms and receives collateral in excess of the fair value of such investments during the period of the loan. Collateral may be cash or securities issued by the U.S. government or its agencies, or the sovereign or provincial debt of foreign countries. Collateral securities cannot be pledged or sold by the university unless the borrower defaults. Loans of domestic equities and all fixed-income securities are initially collateralized at 102% of the fair value of the securities loaned. Loans of foreign equities are initially collateralized at 105%. All borrowers are required to provide additional collateral by the next business day if the value falls to less than 100% of the fair value of the securities loaned. The university earns interest and dividends on the collateral held during the loan period, as well as a fee from the brokerage firm, and is obligated to pay a fee and a rebate to the borrower. The university receives the net investment income. Securities on loan for cash collateral are not considered to be categorized. As of June 30, 2004, the university had no credit risk exposure to borrowers, because the amounts the university owed the borrowers exceeded the amounts the borrowers owed the university. The university is fully indemnified by its custodial bank against any losses incurred as a result of borrower default.

Securities loans immediately terminate upon notice by either the university or the borrower. Cash collateral is invested by the university's lending agent in a short-term investment pool in the university's name, with guidelines approved by the university. As of June 30, 2004, the securities in this pool had a weighted average maturity of 149 days.

The State Department of Insurance permits SCIF to lend a certain portion of its securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. A third-party lending agent has been contracted to lend U.S. Treasury notes and bonds. Collateral, in the form of cash and other securities, is adjusted daily and is required at approximately 102% of the fair value of securities loaned. Collateral securities received are not permitted to be pledged or sold unless the borrower defaults. The maximum loan term is one year. In accordance with SCIF's investment guidelines, cash collateral was invested in short-term investments at December 31, 2003, with maturities matching the related loans. Interest income on these investments is shared by the borrower, the third-party lending agent, and SCIF.

Table 2 presents the investments of the discretely presented component units by credit risk category.

Table 2

Schedule of Investments – Discretely Presented Component Units
June 30, 2004
(amounts in thousands)

	Credit Risk Category 1	Credit Risk Category 2	Credit Risk Category 3	Total Fair Value*
Separately invested funds subject to categorization				
Equity securities	$ 3,635,980	$ 614,743	$ —	$ 4,250,723
Securities lending collateral	3,654,529	—	—	3,654,529
Mortgage loans and notes	3,549,931	3,431	—	3,553,362
U.S. government and agency securities	11,530,305	157,821	—	11,688,126
Commercial paper	6,994	—	—	6,994
Corporate bonds	4,080,911	7,269	—	4,088,180
Investment agreements	—	1,280,653	—	1,280,653
Other investments	1,569,567	87,424	—	1,656,991
Total separately invested funds subject to categorization	**28,028,217**	**2,151,341**	**—**	**30,179,558**
Separately invested funds not subject to categorization				
Investments held by broker-dealers under securities loans with cash collateral				4,665,565
Real estate				96,726
Venture capital and private equity funds				162,760
Investment agreements				863,232
Mutual funds				501,992
Insurance contracts				1,206
Mortgage loans				58,081
Other investments				626,253
Total separately invested funds not subject to categorization				**6,975,815**
Total investments	**$ 28,028,217**	**$ 2,151,341**	**$ —**	**37,155,373**
Less: current investments				11,759,916
Total noncurrent investments				**$ 25,395,457**

*Investments are reported at fair value except for $2,096,937 for investment agreements that are reported at cost.

NOTE 4: ACCOUNTS RECEIVABLE

Table 3 presents the disaggregation of accounts receivable attributable to taxes, interest expense reimbursements, Lottery retailer collections, and unemployment program receipts. Other receivables are for interest, gifts, grants, various fees, penalties, and other charges. The adjustment for the fiduciary funds represents amounts due from fiduciary funds that were reclassified as external receivables on the government-wide Statement of Net Assets.

Table 3

Schedule of Accounts Receivable
June 30, 2004
(amounts in thousands)

	Taxes	Reimbursement of Accrued Interest Expense	Lottery Retailers	Unemployment Programs	Other	Total
Current governmental activities						
General Fund	$ 7,318,300	$ —	$ —	$ —	$ 151,869	$ 7,470,169
Federal Fund	—	—	—	—	10,182	10,182
Transportation Construction Fund	253,284	—	—	—	91,049	344,333
Nonmajor governmental funds	257,735	—	—	—	984,403	1,242,138
Internal service funds	—	—	—	—	40,883	40,883
Adjustment:						
Fiduciary funds	—	—	—	—	16,613	16,613
Total current governmental activities	**$ 7,829,319**	**$ —**	**$ —**	**$ —**	**$ 1,294,999**	**$ 9,124,318**
Amounts not scheduled for collection during the subsequent year	**$ 893,482**	**$ —**	**$ —**	**$ —**	**$ —**	**$ 893,482**
Current business-type activities						
Water Resources Fund	—	—	—	—	86,648	86,648
Public Buildings Construction Fund	—	118,116	—	—	—	118,116
State Lottery Fund	—	—	151,110	—	—	151,110
Unemployment Programs Fund	—	—	—	143,414	—	143,414
Nonmajor enterprise funds	—	—	—	—	46,961	46,961
Adjustment:						
Account reclassification	—	(118,116)	—	—	(10,201)	(128,317)
Total current business-type activities	**$ —**	**$ —**	**$ 151,110**	**$ 143,414**	**$ 123,408**	**$ 417,932**
Amounts not scheduled for collection during the subsequent year	**$ —**	**$ —**	**$ —**	**$ 49,371**	**$ 104,000**	**$ 153,371**

NOTE 5: RESTRICTED ASSETS

Table 4 presents a summary of the legal restrictions placed on assets in the enterprise funds of the primary government.

Table 4

Schedule of Restricted Assets
June 30, 2004
(amounts in thousands)

	Cash and Pooled Investments	Investments	Due From Other Governments	Loans Receivable	Other	Total
Primary government						
Debt service	$ 2,015,029	$ 119,763	$ 55,740	$ 697,323	$ 9,222	$ 2,897,077
Construction	17,091	—	—	—	—	17,091
Operations	1,992,884	—	—	—	—	1,992,884
Total primary government	**4,025,004**	**119,763**	**55,740**	**697,323**	**9,222**	**4,907,052**
Discretely presented component units						
Nonmajor component units – debt service.....................	29,930	60,138	—	—	—	90,068
Total discretely presented component units	**29,930**	**60,138**	**—**	**—**	**—**	**90,068**
Total restricted assets	**$ 4,054,934**	**$ 179,901**	**$ 55,740**	**$ 697,323**	**$ 9,222**	**$ 4,997,120**

NOTE 6: NET INVESTMENT IN DIRECT FINANCING LEASES

The State Public Works Board, an agency that accounts for its activities as an enterprise fund, has entered into lease-purchase agreements with various other primary government agencies, the University of California, and certain local agencies. Payments from these leases will be used to satisfy the principal and interest requirements of revenue bonds issued by the State Public Works Board.

The minimum lease payments to be received by the State Public Works Board for the primary government are summarized in Table 5.

Table 5

Schedule of Minimum Lease Payments to Be Received by the State Public Works Board for the Primary Government

(amounts in thousands)

Year Ending June 30	Primary Government Agencies	University of California	Local Agencies	Total
2005	$ 428,841	$ 119,934	$ 60,479	$ 609,254
2006	412,243	114,998	60,495	587,736
2007	371,508	113,734	59,912	545,154
2008	369,673	113,968	60,133	543,774
2009	363,037	111,973	59,842	534,852
2010-2014	1,587,658	522,850	275,933	2,386,441
2015-2019	1,357,423	364,041	159,974	1,881,438
2020-2024	551,575	210,078	4,100	765,753
2025-2029	188,389	9,029	—	197,418
Total minimum lease payments	**5,630,347**	**1,680,605**	**740,868**	**8,051,820**
Less: unearned income	2,080,627	665,959	230,016	2,976,602
Net investment in direct financing leases	**$ 3,549,720**	**$ 1,014,646**	**$ 510,852**	**$ 5,075,218**

NOTE 7: CAPITAL ASSETS

Table 6 summarizes the capital activity for the primary government, which includes $4.6 billion in capital assets related to capital leases.

Table 6

Schedule of Changes in Capital Assets – Primary Government
June 30, 2004
(amounts in thousands)

	Beginning Balance *	Additions	Deductions	Ending Balance
Governmental activities				
Capital assets not being depreciated				
Land **	$ 13,789,073	$ 615,648	$ 21,027	$ 14,383,694
State highway infrastructure **	54,106,654	361,071	—	54,467,725
Collections	34,805	535	2,945	32,395
Construction in progress	3,941,301	1,838,820	996,930	4,783,191
Total capital assets not being depreciated	**71,871,833**	**2,816,074**	**1,020,902**	**73,667,005**
Capital assets being depreciated				
Buildings and improvements	14,213,182	860,284	350,346	14,723,120
Infrastructure	303,267	96,290	22,382	377,175
Equipment and other assets	3,867,808	262,270	211,086	3,918,992
Total capital assets being depreciated	**18,384,257**	**1,218,844**	**583,814**	**19,019,287**
Less accumulated depreciation for:				
Buildings and improvements	4,179,839	481,378	202,164	4,459,053
Infrastructure	105,811	29,101	15,765	119,147
Equipment and other assets	2,720,446	367,472	227,336	2,860,582
Total accumulated depreciation	**7,006,096**	**877,951**	**445,265**	**7,438,782**
Total capital assets being depreciated, net	**11,378,161**	**340,893**	**138,549**	**11,580,505**
Governmental activities, capital assets, net	**$ 83,249,994**	**$ 3,156,967**	**$ 1,159,451**	**$ 85,247,510**
Business-type activities				
Capital assets not being depreciated				
Land	$ 16,999	$ 6,257	$ —	$ 23,256
Construction in progress	753,229	966,966	293,753	1,426,442
Total capital assets not being depreciated	**770,228**	**973,223**	**293,753**	**1,449,698**
Capital assets being depreciated				
Buildings and improvements	6,203,429	361,013	113,513	6,450,929
Infrastructure	1,205,230	70	65	1,205,235
Equipment and other assets	151,025	11,517	59,947	102,595
Total capital assets being depreciated	**7,559,684**	**372,600**	**173,525**	**7,758,759**
Less accumulated depreciation for:				
Buildings and improvements	2,256,303	230,260	81,681	2,404,882
Infrastructure	638,328	19,471	1	657,798
Equipment and other assets	118,699	18,249	61,366	75,582
Total accumulated depreciation	**3,013,330**	**267,980**	**143,048**	**3,138,262**
Total capital assets being depreciated, net	**4,546,354**	**104,620**	**30,477**	**4,620,497**
Business-type activities, capital assets, net	**$ 5,316,582**	**$ 1,077,843**	**$ 324,230**	**$ 6,070,195**

* Restated

** Includes retroactive reporting of infrastructure assets of $10,224,990 for Land and $53,703,777 for State highway infrastructure.

Table 7 summarizes the depreciation expense charged to the activities of the primary government.

Table 7

Schedule of Depreciation Expense – Primary Government
June 30, 2004
(amounts in thousands)

	Amount
Governmental activities	
General government	$ 85,280
Education	355,416
Health and human services	32,086
Resources	47,217
State and consumer services	33,641
Business and transportation	90,668
Correctional programs	148,597
Internal service funds (charged to the activities that utilize the fund)	85,046
Total depreciation expense – governmental activities	**877,951**
Business-type activities	
Enterprise	**267,980**
Total primary government	**$ 1,145,931**

Table 8 summarizes the capital activity for discretely presented component units.

Table 8

Schedule of Changes in Capital Assets – Discretely Presented Component Units
June 30, 2004
(amounts in thousands)

	Beginning Balance*	Additions	Deductions	Ending Balance
Capital assets not being depreciated				
Land	$ 494,273	$ 50,033	$ 11,498	$ 532,808
Collections	229,243	7,648	413	236,478
Construction in progress	2,335,109	846,043	159,283	3,021,869
Total capital assets not being depreciated	**3,058,625**	**903,724**	**171,194**	**3,791,155**
Capital assets being depreciated				
Buildings and improvements	13,046,330	1,131,269	30,803	14,146,796
Equipment and other depreciable assets	7,120,240	703,894	316,180	7,507,954
Infrastructure	318,983	42,038	200	360,821
Total capital assets being depreciated	**20,485,553**	**1,877,201**	**347,183**	**22,015,571**
Less accumulated depreciation for:				
Buildings and improvements	4,830,515	438,796	(6,796)	5,276,107
Equipment and other depreciable assets	4,788,788	511,349	270,492	5,029,645
Infrastructure	140,285	13,823	123	153,985
Total accumulated depreciation	**9,759,588**	**963,968**	**263,819**	**10,459,737**
Total capital assets being depreciated, net	**10,725,965**	**913,233**	**83,364**	**11,555,834**
Capital assets, net	**$ 13,784,590**	**$ 1,816,957**	**$ 254,558**	**$ 15,346,989**

* Restated

NOTE 8: ACCOUNTS PAYABLE

Accounts payable are amounts due to taxpayers, vendors, customers, beneficiaries, and employees related to different programs. Table 9 presents detail of the accounts payable.

The adjustment for the fiduciary funds represents amounts due to fiduciary funds that were reclassified as external payables on the government-wide Statement of Net Assets.

Table 9

Schedule of Accounts Payable
June 30, 2004
(amounts in thousands)

	Education	Health and Human Services	Resources	Business and Transportation	General Government and Others	Total
Governmental activities						
General Fund	$ 321,680	$ 76,850	$ 134,715	$ 880	$ 481,759	$ 1,015,884
Federal Fund	223,480	358,324	60,563	218,177	52,235	912,779
Transportation Construction Fund	4	—	—	148,735	1,810	150,549
Nonmajor governmental funds	431,668	500,834	160,210	842,461	395,592	2,330,765
Internal service funds	—	38,053	6,440	16,496	91,338	152,327
Adjustment:						
Fiduciary funds	2,513,505	3,588,015	—	24,405	383,584	6,509,509
Total governmental activities	**$ 3,490,337**	**$ 4,562,076**	**$ 361,928**	**$ 1,251,154**	**$ 1,406,318**	**$ 11,071,813**
Business-type activities						
Electric Power Fund	$ —	$ —	$ 452,000	$ —	$ —	$ 452,000
Water Resources Fund	—	—	39,156	—	—	39,156
Public Building Construction Fund	—	—	—	—	43,772	43,772
State Lottery Fund	—	—	—	—	23,084	23,084
Nonmajor enterprise funds	24,204	588	37	6,847	2,583	34,259
Adjustment:						
Fiduciary funds	—	4,461	—	—	—	4,461
Total business-type activities	**$ 24,204**	**$ 5,049**	**$ 491,193**	**$ 6,847**	**$ 69,439**	**$ 596,732**

NOTE 9: SHORT-TERM FINANCING

As part of its cash management program, the State regularly issues short-term obligations to meet cash flow needs. The State issues revenue anticipation notes (RANs) to partially fund timing differences between revenues and expenditures. A significant portion of the General Fund revenues are received in the latter half of the fiscal year, while disbursements are paid more evenly throughout the fiscal year. If additional external cash flow borrowing is required, the State issues revenue anticipation warrants (RAWs). On June 18, 2003, the State issued $11.0 billion of RAWs, to fund cash flow needs for the 2003-04 fiscal year, including the repayment of $12.5 billion in RANs issued in the 2002-03 fiscal year. In addition to the RAWs, the State also issued $3.0 billion of RANs in October 2003.

During the 2002-03 and 2003-04 fiscal years, the State entered into agreements with various financial institutions to provide credit and liquidity for the RAWs and a portion of the RANs. The RAWs and RANs were repaid on June 16, 2004, and June 23, 2004, respectively.

The California Housing Finance Agency, a discretely presented component unit, entered into an agreement with a financial institution to provide a line of credit for short-term borrowings of up to $100 million. At June 30, 2004, draws totaling $42 million were outstanding.

NOTE 10: LONG-TERM OBLIGATIONS

As of June 30, 2004, the primary government had long-term obligations totaling $94.4 billion. Of that amount, $4.2 billion is due within one year, and includes $271 million in outstanding commercial paper that had been scheduled to be refunded by general obligation bonds issued during the fiscal year. This commercial paper was refunded in July 2004.

The large increase in the governmental activities general obligation bonds payable was the result of the issuance of $10.9 billion of Economic Recovery Bonds. The other long-term obligations for governmental activities consist of $2.7 billion for workers' compensation claims, $2.1 billion for reimbursement of costs mandated by the State, $1.2 billion for outstanding debts to schools related to the Proposition 98 funding guarantee, $1.1 billion for net pension obligations, $509 million owed for lawsuits, and the University of California unfunded pension liability of $83 million. The compensated absences will be liquidated by the General Fund, special revenue funds, capital projects funds, and internal service funds. Workers' compensation and capital leases will be liquidated by the General Fund, special revenue funds, and internal service funds. Loans payable, net pension obligations, Proposition 98 funding guarantee, lawsuits, reimbursement of costs incurred by local agencies and school districts for costs mandated by the State, and the University of California pension liability will be liquidated by the General Fund.

The decrease in benefits payable of the business-type activities resulted from the restatement of the beginning balance because the Public Employees' Benefits Fund was reclassified as a discretely presented component unit. The $565 million in other long-term obligations for business-type activities is mainly for advance collections. These other long-term obligations do not have required payment schedules, or they will be paid when funds are appropriated. The changes in the long-term obligations during the year ended June 30, 2004, are summarized in Table 10.

Table 10

Schedule of Changes in Long-Term Obligations
(amounts in thousands)

	Balance July 1, 2003	Additions	Deductions	Balance June 30, 2004	Due Within One Year	Noncurrent Liabilities
Governmental activities						
Loans payable	$ 841,900	$ 598,681	$ 560,355	$ 880,226	$ —	$ 880,226
Compensated absences payable	1,576,230	902,513	947,344	1,531,399	96,303	1,435,096
Certificates of participation and commercial paper	1,856,702	759,653	1,766,995	849,360	282,050	567,310
Capital lease obligations	3,906,423	85,390	246,403	3,745,410	250,368	3,495,042
General obligation bonds payable	26,757,371	17,625,085	457,820	43,924,636	1,314,047	42,610,589
Revenue bonds payable	3,848,315 *	4,347,570	94,030	8,101,855	76,625	8,025,230
Other long-term obligations	5,997,238	2,851,684	1,108,615	7,740,307	420,742	7,319,565
Total	**$ 44,784,179**	**$ 27,170,576**	**$ 5,181,562**	**$ 66,773,193**	**$ 2,440,135**	**$ 64,333,058**
Business-type activities						
Benefits payable	$ 21,935 *	$ —	$ 2,486	$ 19,449	$ —	$ 19,449
Lottery prizes and annuities	2,522,593	1,728,525	1,790,455	2,460,663	576,812	1,883,851
Compensated absences payable	32,759	23,142	12,701	43,200	11,430	31,770
Certificates of participation and commercial paper	101,528	170,733	175,082	97,179	—	97,179
General obligation bonds payable	2,809,275	—	593,475	2,215,800	245,695	1,970,105
Revenue bonds payable	21,557,908	1,749,766	1,068,658	22,239,016	888,363	21,350,653
Other long-term obligations	583,527 *	492	19,500	564,519	5,055	559,464
Total	**$ 27,629,525**	**$ 3,672,658**	**$ 3,662,357**	**$ 27,639,826**	**$ 1,727,355**	**$ 25,912,471**

* Restated

NOTE 11: CERTIFICATES OF PARTICIPATION

Debt service requirements for certificates of participation, which are financed by lease payments from governmental activities, are shown in Table 11. The certificates of participation were used to finance the acquisition and construction of state office buildings.

Table 11

Schedule of Debt Service Requirements for Certificates of Participation – Primary Government
(amounts in thousands)

Year Ending June 30	Principal	Interest	Total
2005	$ 10,765	$ 3,069	$ 13,834
2006	10,864	3,341	14,205
2007	6,190	3,448	9,638
2008	5,954	3,689	9,643
2009	5,807	3,831	9,638
2010-2014	32,300	16,983	49,283
2015-2019	20,480	625	21,105
Total	**$ 92,360**	**$ 34,986**	**$ 127,346**

Debt service requirements for certificates of participation for the University of California, a discretely presented component unit, are shown in Table 12.

Table 12

Schedule of Debt Service Requirements for Certificates of Participation – University of California – Discretely Presented Component Unit

(amounts in thousands)

Year Ending June 30	Principal	Interest	Total
2005	$ 6,920	$ 7,135	$ 14,055
2006	7,270	6,783	14,053
2007	7,640	6,408	14,048
2008	8,020	6,020	14,040
2009	8,490	5,615	14,105
2010-2014	25,115	23,056	48,171
2015-2019	18,305	18,302	36,607
2020-2024	21,165	13,445	34,610
2025-2029	27,335	7,172	34,507
2030-2034	11,880	964	12,844
Total	**$ 142,140**	**$ 94,900**	**$ 237,040**

NOTE 12: COMMERCIAL PAPER AND OTHER LONG-TERM BORROWINGS

The primary government has two commercial paper borrowing programs: a general obligation commercial paper program, and an enterprise fund commercial paper program for the Department of Water Resources. Under these programs, commercial paper may be issued at prevailing rates for periods not to exceed 270 days from the date of issuance. The proceeds from the issuance of commercial paper are restricted primarily for construction costs of general obligation bond program projects and of certain state water projects. The general obligation and enterprise fund commercial paper is retired by long-term general obligation debt, and it is therefore considered a noncurrent liability.

To provide liquidity for the programs, the State has entered into a revolving credit agreement with commercial banks. The current agreement for the general obligation commercial paper program, effective December 16, 2003, authorizes the issuance of notes in an aggregate principal amount not to exceed $1.5 billion, with the aggregate interest amount thereon not to exceed $40 million. The current agreement for the enterprise fund commercial paper program authorizes the issuance of notes in an aggregate principal amount not to exceed $141.5 million, with the aggregate interest amount thereon not to exceed $8.5 million. As of June 30, 2004, the enterprise fund commercial paper program had $10.5 million in outstanding notes.

During the fiscal year ended June 30, 2004, the primary government issued $757 million in commercial paper and $1.1 billion in long-term general obligation bonds to refund outstanding commercial paper. However, by June 30, 2004, only $815 million of the $1.1 billion had been used to repay outstanding commercial paper. The remaining $271 million was used to repay commercial paper in July 2004. In addition, the General Fund directly retired $6.5 million in outstanding commercial paper during the fiscal year. As of June 30, 2004, the general obligation commercial paper program had $757 million in outstanding commercial paper notes, of which $271 million is considered a current liability.

The primary government has a revenue bond anticipation note (BAN) program that consists of borrowing for capital improvements on certain campuses of the California State University. As of June 30, 2004, $87 million in outstanding BANs existed in anticipation of issuing housing revenue bonds to the public.

The University of California, a discretely presented component unit, has other borrowings consisting of contractual obligations resulting from the acquisition of land or buildings, and the construction and renovation of certain facilities. Included in other borrowings, which total approximately $546 million, are various unsecured financing agreements with commercial banks that total approximately $189 million.

The University of California established a $550 million commercial paper program with tax-exempt and taxable components. The program is supported by the legally available unrestricted investments balance in the University of California's Short-Term Investment Pool. Commercial paper has been issued to provide for interim financing of the construction, renovation, and acquisition of certain facilities and equipment. Commercial paper is secured by a pledge of the net revenues generated by the enterprise financed, not by any encumbrance, mortgage, or other pledge of property, and does not constitute a general obligation of the University of California. At June 30, 2004, outstanding tax-exempt and taxable commercial paper was $430 million and $120 million, respectively.

NOTE 13: LEASES

The aggregate amount of lease commitments for facilities and equipment of the primary government in effect as of June 30, 2004, was approximately $6.8 billion. This amount does not include any future escalation charges for real estate taxes and operating expenses. Primary government leases that are classified as operating leases, in accordance with the applicable standards, contain clauses providing for termination. Operating lease expenditures are recognized as incurred over the lease term. It is expected that, in the normal course of business, most of these operating leases will be replaced by similar leases.

The total present value of minimum capital lease payments for the primary government is composed of $9 million from internal service funds and $3.7 billion from other governmental activities. The additions and deductions of capital lease obligations may be found in Note 10, Long-Term Obligations. Also reported in Note 10 are the current and noncurrent portions of the capital lease obligations. Lease expenditures for the year ended June 30, 2004, amounted to approximately $775 million.

Included in the capital lease commitments are lease-purchase agreements that certain state agencies have entered into with the State Public Works Board, an enterprise fund agency, amounting to a present value of net minimum lease payments of $3.5 billion. This amount represents 95% of the total present value of minimum lease payments of the primary government. Also included in the capital lease commitments are some lease-purchase agreements to acquire equipment.

The capital lease commitments do not include $721 million of lease-purchase agreements with building authorities that are blended component units. These building authorities acquire or develop office buildings and then lease the facilities to state agencies. Upon expiration of the lease, title passes to the primary government. The costs of the buildings and the related outstanding revenue bonds and certificates of participation are reported in the government-wide financial statements. Accordingly, the lease receivables or capital lease obligations associated with these buildings are not included in the financial statements.

Future minimum lease commitments of the primary government are summarized in Table 13.

Table 13

Schedule of Future Minimum Lease Commitments – Primary Government
(amounts in thousands)

		Capital Leases		
Year Ending June 30	**Operating Leases**	**Internal Service Funds**	**Other Governmental Activities**	**Total**
2005	$ 248,846	$ 4,772	$ 484,723	$ 738,341
2006	182,793	1,221	445,274	629,288
2007	125,284	791	392,487	518,562
2008	87,880	790	388,858	477,528
2009	66,656	794	378,113	445,563
2010-2014	128,564	2,434	1,650,382	1,781,380
2015-2019	48,497	—	1,409,975	1,458,472
2020-2024	3,139	—	594,641	597,780
2025-2029	3	—	188,388	188,391
2030-2034	3	—	—	3
2035-2039	3	—	—	3
2040-2044	3	—	—	3
2045-2049	2	—	—	2
Total minimum lease payments	**$ 891,673**	**10,802**	**5,932,841**	**$ 6,835,316**
Less: amount representing interest		1,428	2,196,805	
Present value of net minimum lease payments		**$ 9,374**	**$ 3,736,036**	

The aggregate amount of discretely presented component units' lease commitments for land, facilities, and equipment in effect as of June 30, 2004, was approximately $2.5 billion. Table 14 presents the future minimum lease commitments for the University of California and the State Compensation Insurance Fund. Operating lease expenditures for the year ended June 30, 2004, amounted to approximately $215 million for discretely presented component units.

Table 14

Schedule of Future Minimum Lease Commitments – Discretely Presented Component Units
(amounts in thousands)

Year Ending June 30	University of California Capital	University of California Operating	State Compensation Insurance Fund Operating	Total
2005	$ 158,965	$ 86,210	$ 49,705	$ 294,880
2006	148,542	70,783	42,366	261,691
2007	135,060	57,870	30,788	223,718
2008	129,644	46,879	24,061	200,584
2009	134,943	34,823	16,858	186,624
2010-2014	526,215	50,696	37,021	613,932
2015-2019	401,559	3,373	—	404,932
2020-2024	247,344	3,478	—	250,822
2025-2029	9,151	3,897	—	13,048
2030-2034	—	4,393	—	4,393
2035-2039	—	5,012	—	5,012
2040-2044	—	608	—	608
Total minimum lease payments	**1,891,423**	**$ 368,022**	**$ 200,799**	**$ 2,460,244**
Less: amount representing interest	604,411			
Present value of net minimum lease payments	**$ 1,287,012**			

NOTE 14: COMMITMENTS

As of June 30, 2004, the primary government had commitments of $4.0 billion for certain highway construction projects. These commitments are not included in the reserve for encumbrances in the Federal Fund and the Transportation Construction Fund because the future expenditures related to these commitments are expected to be reimbursed with $909 million from local governments and $3.1 billion in proceeds of approved federal grants. The ultimate liability will not accrue to the State.

The primary government had other commitments totaling $31.4 billion that are not included as a liability on the Balance Sheet or the Statement of Net Assets. These commitments included $16.5 billion in long-term contracts to purchase power that are not included as a liability on the Statement of Net Assets of the Electric Power Fund. In addition, there are variable costs, estimated at $8.5 billion by management, associated with several of the contracts. Purchases will take place in the future, and the commitments will be met with future receipts from charges to residential and commercial energy users. The $31.4 billion in commitments also included loan and grant agreements that totaled approximately $3.7 billion to reimburse other entities for construction projects for school building aid and housing. The constructed assets will not belong to the primary government, whose payments are contingent upon the other entities entering into construction contracts.

In addition to the loan and grant commitments, the primary government had commitments of approximately $1.4 billion for the construction of water projects and the purchase of power, $1.0 billion for state parks, and $274 million for the maintenance and operation of the California State Lottery's automated gaming system and its communication systems and services. These are long-term projects, and all needs of the contracts may not have been defined. The projects will be funded with existing and future program resources or with the proceeds of revenue and general obligation bonds.

As of June 30, 2004, the discretely presented component units had other commitments that are not included as a liability on the Statement of Net Assets. The University of California had authorized construction projects totaling $3.0 billion. The university has also made commitments to make investments in certain investment partnerships pursuant to provisions in the partnership agreements. These commitments totaled $717 million as of June 30, 2004. Other component units had outstanding commitments to provide $295 million for loans under various housing revenue bond programs and $78 million to other governments for infrastructure improvements.

NOTE 15: GENERAL OBLIGATION BONDS

The State Constitution permits the primary government to issue general obligation bonds for specific purposes and in such amounts as approved by a two-thirds majority of both houses of the Legislature and by a majority of voters in a general or direct primary election. The debt service for general obligation bonds is appropriated from the General Fund. Under the State Constitution, the General Fund is used first to support the public school system and public institutions of higher education; it can then be used to service the debt on outstanding general obligation bonds. Enterprise funds and certain other funds reimburse the General Fund for any debt service provided on their behalf.

General obligation bonds that are directly related to, and expected to be paid from, the resources of enterprise funds are included as a liability of such funds in the financial statements. However, the General Fund may be liable for the payment of any principal and interest on these bonds that is not met from the resources of such funds.

As of June 30, $34.5 billion of general obligation bonds had been authorized but not issued. This amount includes $19.9 billion that has been authorized by the applicable finance committee for future issuance in the form of commercial paper notes. Of this amount, $757 million in general obligation indebtedness has been issued in the form of commercial paper notes but not yet retired by long-term bonds.

During the 2001-02 fiscal year, the State adopted its new *Strategic Debt Management Plan*. This plan included shifting from level principal payments to level debt service payments (principal and interest combined), deferring initial principal payments on newly issued general obligations bonds, and issuing variable-rate general obligation bonds. In April 2003, the State sold $1.4 billion of variable-rate general obligation bonds, consisting of $250 million in daily rate, $650 million in weekly rate, and $500 million in auction rate. The interest rates associated with the daily rates and weekly rates are determined by the remarketing agents to be the lowest rate that would allow the bonds to sell on the effective date of such rate at a price (without regard to accrued interest) equal to 100% of the principal amount. The interest is paid on the first business day of each calendar month. The interest rates on the auction-rate bonds are determined by the auction agent through an auction process and the interest is paid on the business day immediately following each auction rate period. Letters of credit were issued to secure payment of principal and interest on the daily and weekly variable-rate bonds. Under these letters of credit, the credit providers pay all principal and interest payments to the bondholders; the State is then required to reimburse the credit providers for the amounts paid, plus interest. There are different credit providers for each series of variable-rate bonds issued. The initial expiration dates of the letters of credit for the daily and weekly variable-rate bonds are April 14, 2008, and April 14, 2006, respectively.

A. New Issuances

On March 2, 2004, voters approved the one-time issuance of up to $15 billion of Economic Recovery Bonds. The debt service for these bonds is payable from and secured by amounts available in the Fiscal Recovery Fund, a special revenue fund, that consists primarily of revenues from a dedicated sales tax. However, the General Fund may be liable for the payment of any principal and interest on the bonds that cannot be paid from the Fiscal Recovery Fund.

In May and June of 2004, the State sold a total of $10.9 billion of Economic Recovery Bonds. Of the $10.9 billion sold, bonds totaling $3.0 billion were sold as variable-rate bonds, consisting of $1.0 billion in daily rate and $2.0 billion in weekly rate. The interest rates associated with the daily rates and weekly rates are determined by the remarketing agents to be the lowest rate that would enable them to sell the bonds for delivery on the effective date of such rate at a price (without regard to accrued interest) equal to 100% of the principal amount. The interest is paid on the first business day of each calendar month. As described in the Official Statement, payment of principal, interest, and purchase upon mandatory or optional tender, for a portion of these bonds, is secured by a direct-pay letter of credit. Payment of principal and interest for another portion of these bonds is secured by a bond insurance policy, together with an insured standby bond purchase agreement upon tender. A separate uninsured standby bond purchase agreement supports the purchase upon tender for the final portion of these bonds, without credit enhancement in the form of an insurance policy or letter of credit related to the payment of principal or interest. The State reimburses its credit providers for any amounts paid, plus interest. There are different credit providers for each series of variable-rate bonds issued. The initial expiration dates for these letters of credit, bond insurance policies, and standby bond purchase agreements are between June 15, 2007, and December 31, 2015.

Another $1.0 billion of the $10.9 billion Economic Recovery Bonds were sold with interest-reset dates of either July 1, 2007, or July 1, 2008. At that time, the bonds are subject to mandatory tender for purchase at a price equal to 100% of the principal amount, plus accrued interest, without premium. Upon mandatory tender, the State will seek to remarket these bonds. The debt service requirements published in the Official Statement differ from the calculation included in Table 15, because the statement presumes a successful remarketing at an interest rate of 3.33% per year, along with the creation of a mandatory sinking fund. The debt service calculation in Table 15 uses the interest rates in effect at year-end, which are the same interest rates in effect until the applicable reset date, and does not assume the future establishment of a sinking fund. In the event of a failed remarketing, the State is required to return all tendered bonds to their initial purchasers and pay an annual interest rate of 11%, until such time there is a successful remarketing of these bonds.

Information on the changes in general obligation bond debt can be found in Note 10, Long-Term Obligations.

B. Debt Service Requirements

Table 15 shows the debt service requirements for all general obligation bonds as of June 30, 2004. The estimated debt service requirements for the $1.4 billion variable-rate general obligation bonds and the $3.0 billion variable-rate Economic Recovery Bonds are calculated using the actual interest rates in effect on June 30, 2004. Sinking fund deposits for the variable-rate general obligation bonds will be set aside in a mandatory sinking fund at the beginning of each fiscal year, starting in the 2015-16 fiscal year and continuing to the 2032-33 fiscal year, based on the schedule provided in the Official Statement. The deposits set aside in any fiscal year, with approval of the State Treasurer and the appropriate bond finance committees, may be applied to the redemption of any other general obligation bonds then outstanding. To the extent that the deposit is not applied by January 31 of each fiscal year, the variable-rate general obligation bonds will be redeemed in whole or in part on an interest payment date in that fiscal year.

Table 15

Schedule of Debt Service Requirements for General Obligation Bonds
(amounts in thousands)

Year Ending	Governmental Activities			Business-type Activities		
June 30	Interest	Principal	Total	Interest	Principal	Total
2005	$ 1,920,164	$ 1,314,047	$ 3,234,211	$ 120,228	$ 245,695	$ 365,923
2006	1,995,902	1,602,120	3,598,022	110,501	126,800	237,301
2007	1,912,230	1,656,195	3,568,425	101,423	129,360	230,783
2008	1,826,134	1,848,377	3,674,511	91,601	136,430	228,031
2009	1,729,788	1,977,295	3,707,083	81,813	135,340	217,153
2010-2014	7,083,694	8,858,627	15,942,321	308,105	476,680	784,785
2015-2019	5,017,307	7,977,025	12,994,332	180,323	572,000	752,323
2020-2024	3,454,128	8,402,885	11,857,013	79,184	184,200	263,384
2025-2029	1,834,319	6,039,550	7,873,869	43,770	98,970	142,740
2030-2034	461,307	4,248,515	4,709,822	12,505	110,325	122,830
Total	**$ 27,234,973**	**$ 43,924,636**	**$ 71,159,609**	**$ 1,129,453**	**$ 2,215,800**	**$ 3,345,253**

C. General Obligation Bond Defeasances

1. Current Year

On July 1, 2003, the primary government issued $869 million in various-purpose general obligation refunding bonds to current and advance refund $870 million in general obligation bonds maturing in 2003-04. The primary government placed the net proceeds into an irrevocable trust to pay the debt service on the refunded bonds. As a result, the refunded bonds are considered defeased and the liability for those bonds has been removed from the financial statements. The refunding increased overall debt service payments by $609 million and resulted in an economic gain of $68 million. The economic gain is the difference between the present value of the old debt service requirements and the present value of the new debt service requirements, discounted at 5.5% per year over the life of the new bonds. The State executed this refunding to achieve a significant one-time reduction in debt service requirements and to aid the transition to level debt service payments.

On June 29, 2004, the primary government issued $215 million in various-purpose general obligation refunding bonds to current and advance refund $218 million in general obligation bonds maturing in 2011, 2012, 2013, 2016, and 2017. The primary government placed the net proceeds into an irrevocable trust to pay the debt service on the refunded bonds. As a result, the refunded bonds are considered to be defeased and the liability for those bonds has been removed from the financial statements. This advance refunding reduced the debt service payments by $11.9 million and resulted in an economic gain of $8.5 million, using a discounted rate of 4.1%.

On December 29, 2003, the primary government issued $125 million in veterans home-purchase revenue bonds that were used to refund $125 million of veterans general obligation bonds. The advance refunding reduced the debt service payments by $94 million and resulted in an economic gain of $82 million, using a discounted rate of 3%.

2. Prior Years

In prior years, the primary government placed the proceeds of the refunding bonds in a special irrevocable escrow trust account with the State Treasury to provide for all future debt service payments on defeased bonds. The assets of the trust accounts and the liability for defeased bonds are not included in the State's financial statements. As of June 30, 2004, the outstanding balance of general obligation bonds defeased in prior years was approximately $1.3 billion.

NOTE 16: REVENUE BONDS

A. Governmental Activities

During the fiscal year ended June 30, 2004, two bonds were issued to fund activities in the Transportation Construction Fund. The California Infrastructure and Economic Development Bank is authorized by state law to issue Bay Area Toll Bridges Seismic Retrofit Revenue Bonds. The purpose of these bonds is to finance a portion of the seismic retrofitting of some of the toll bridges owned by the State that serve the Bay Area. These bonds are secured and payable from a $1 per vehicle seismic surcharge from all toll-paying vehicular traffic on the Bay Area bridges. The State Treasurer is authorized by state law to issue Federal Highway Grant Anticipation Revenue Vehicles (GARVEE bonds). The purpose of these bonds is to accelerate the funding and construction of critical transportation infrastructure projects in order to provide congestion relief benefits to the public significantly sooner than traditional funding mechanisms. These bonds are secured and payable from the annual federal appropriation for the State's federal-aid transportation projects. The primary government has no legal liability for the payment of principal and interest on these revenue bonds. Both of these bonds are included in the governmental activities column of the government-wide Statement of Net Assets.

The California State University, Channel Islands Financing Authority, a blended component unit in the California State University Programs Fund, issues revenue bonds to provide funding for public capital improvements serving the California State University, Channel Islands. These bonds are secured and payable from special taxes, tax increment revenues, and pledged rental housing revenues of the California State University, Channel Islands Site Authority, which is also a blended component unit in the California State University Programs Fund. The primary government has no legal liability for the payment of principal and interest on these revenue bonds. The bonds are included in the governmental activities column of the government-wide Statement of Net Assets.

The Golden State Tobacco Securitization Corporation (GSTSC), a blended component unit, is authorized by state law to issue asset-backed bonds to purchase the State's rights to future revenues from the Master Settlement Agreement with participating tobacco companies. These bonds are secured by and payable solely from future Tobacco Settlement Revenue. The primary government has no legal liability for the payment of principal and interest on these bonds. These bonds are included in the governmental activities column of the government-wide Statement of Net Assets.

Under state law, certain building authorities may issue revenue bonds. These bonds are issued for the purpose of acquiring and constructing buildings for public education purposes and for the purpose of constructing state office buildings. Leases with state agencies pay the principal and interest on the revenue bonds issued by the building authorities. The primary government has no legal liability for the payment of principal and interest on these revenue bonds. These revenue bonds are included in the governmental activities column of the government-wide Statement of Net Assets.

B. Business-type Activities

Revenue bonds that are directly related to, and expected to be paid from, the resources of enterprise funds are included in the accounts of such funds. Principal and interest on revenue bonds are payable from the pledged revenues of the respective funds of agencies that issued the bonds. The General Fund has no legal liability for payment of principal and interest on revenue bonds.

Revenue bonds to acquire, construct, or renovate state facilities or to refund outstanding revenue bonds in advance of maturity are issued for water resources, public building construction, and certain nonmajor enterprise funds. Revenue bonds were used to repay advances from the General Fund and loans from financial institutions that were used to finance electric power purchases for resale to utility customers.

C. Discretely Presented Component Units

The University of California issues revenue bonds to finance the construction, renovation, and acquisition of certain facilities and equipment.

Under state law, the California Housing Finance Agency (CalHFA) issues fixed- and variable-rate revenue bonds to make loans to finance housing developments and to finance the acquisition of homes by low- and moderate-income families. Variable-rate debt is typically tied to a common index, such as the Bond Market Association (BMA) or the London Interbank Offered Rate (LIBOR) and is reset periodically.

Table 16 shows revenue bonds outstanding of the primary government and the discretely presented component units.

Table 16

Schedule of Revenue Bonds Outstanding
June 30, 2004
(amounts in thousands)

Primary government		
Governmental activities		
Transportation Construction Fund	$	1,775,285
Nonmajor governmental funds		
California State University Programs Fund		96,275
Golden State Tobacco Securitization Corporation Fund		5,511,705
Building authorities		718,590
Total governmental activities		**8,101,855**
Business-type activities		
Electric Power Fund		11,414,000
Water Resources Fund		2,449,856
Public Building Construction Fund		6,033,362
Nonmajor enterprise funds		2,341,798
Total business-type activities		**22,239,016**
Total primary government		**30,340,871**
Discretely presented component units		
University of California		4,388,314
California Housing Finance Agency		7,873,007
Nonmajor component units		589,472
Total discretely presented component units		**12,850,793**
Total	**$**	**43,191,664**

Table 17 shows the debt service requirements for fixed- and variable-rate bonds. It excludes certain unamortized refunding costs, premiums, discounts, and other costs that are included in Table 16.

Table 17

Schedule of Debt Service Requirements for Revenue Bonds
(amounts in thousands)

Year Ending June 30	Primary Government				Discretely Presented Component Units	
	Governmental Activities		Business-type Activities			
	Principal	Interest	Principal	Interest*	Principal	Interest*
2005	$ 76,625	$ 455,798	$ 845,472	$ 937,366	$ 816,573	$ 378,944
2006	91,280	452,952	874,520	900,153	321,625	363,890
2007	112,305	449,451	867,513	863,659	611,665	350,732
2008	132,720	444,690	903,182	822,708	370,359	336,144
2009	139,895	438,771	952,580	785,277	417,241	339,602
2010-2014	721,280	2,092,115	5,213,059	3,209,039	2,085,611	1,395,915
2015-2019	659,305	1,921,971	6,173,620	1,885,025	2,172,925	1,028,177
2020-2024	835,075	1,727,704	4,578,403	742,944	1,969,812	691,482
2025-2029	973,785	1,486,853	1,304,510	223,869	1,991,689	408,554
2030-2034	1,347,885	1,172,845	252,580	28,948	1,563,185	159,754
2035-2039	1,777,460	713,689	35,200	1,611	505,030	41,599
2040-2044	1,234,240	173,469	—	—	24,460	499
Total	**$ 8,101,855**	**$ 11,530,308**	**$ 22,000,639**	**$ 10,400,599**	**$ 12,850,175**	**$ 5,495,292**

*Includes interest on variable-rate bonds based on rates in effect on June 30, 2004.

Table 18 shows debt service requirements as of June 30, 2004, for variable-rate debt included in Table 17, as well as net swap payments, assuming that current interest rates remain the same for their term. As interest rates vary, variable-rate bond interest payments and net swap payments will vary.

Table 18

Schedule of Debt Service and Swap Requirements for Variable-Rate Revenue Bonds
(amounts in thousands)

	Primary Government				Discretely Presented Component Units			
	Business-type Activities							
Year Ending June 30	Principal	Interest*	Interest Rate* Swap Net	Total	Principal	Interest*	Interest Rate* Swap Net	Total
2005	$ —	$ 15,000	$ 33,000	$ 48,000	$ 75,970	$ 43,869	$ 141,358	$ 261,197
2006	—	15,000	33,000	48,000	83,450	46,446	145,043	274,939
2007	—	15,000	33,000	48,000	91,510	44,638	138,878	275,026
2008	—	15,000	33,000	48,000	106,205	41,955	130,081	278,241
2009	—	15,000	33,000	48,000	110,475	39,165	120,319	269,959
2010-2014	852,000	64,000	142,000	1,058,000	601,865	157,432	474,221	1,233,518
2015-2019	578,000	12,000	29,000	619,000	702,325	102,573	305,716	1,110,614
2020-2024	—	—	—	—	827,050	62,866	189,601	1,079,517
2025-2029	—	—	—	—	929,935	34,430	106,438	1,070,803
2030-2034	—	—	—	—	822,440	12,475	38,818	873,733
2035-2039	—	—	—	—	97,240	1,092	3,586	101,918
Total	**$ 1,430,000**	**$ 151,000**	**$ 336,000**	**$ 1,917,000**	**$ 4,448,465**	**$ 586,941**	**$ 1,794,059**	**$ 6,829,465**

*Based on rates in effect on June 30, 2004.

D. Primary Government Variable Rate/Swap Disclosure

Objective: The Department of Water Resources (DWR) entered into interest-rate swap agreements with various counterparties to reduce variable-interest-rate risk for the Electric Power Fund. The swaps create a synthetic fixed rate. DWR agreed to make fixed-rate payments and receive floating-rate payments on notional amounts equal to a portion of the principal amount of this variable-rate debt.

Terms and Fair Value: The terms and fair value of the swap agreements entered into by DWR, all of which became effective February 1, 2003, are summarized in Table 19. The notional amounts of the swaps match the principal amounts of the associated debt. The swap agreements contain scheduled reductions to outstanding notional amounts that follow scheduled amortization of the associated debt. Most swaps had a negative fair value as of June 30, 2004, because interest rates had declined. The fair values were provided by the counterparties using the par value or the marked-to-market method.

Credit Risk: As of June 30, 2004, DWR was not exposed to significant credit risk because of the swaps' small positive and negative fair values. However, should interest rates increase and the fair values become more positive, DWR would be exposed to credit risk in the amount of the swaps' fair value. DWR has a total of nine swap agreements with six different counterparties. Three swaps, approximating 35% of the total notional value, are with a counterparty that has Moody's Investors Service, Fitch Ratings, and Standard & Poor's (S&P) credit ratings of Aaa, AAA, and AAA, respectively. Of the remaining swaps, two are held with a single counterparty and approximate 21% of the outstanding notional value; that counterparty has Moody's, Fitch's, and S&P's credit ratings of Aa3, AA-, and A+, respectively. The remaining four swaps are with separate counterparties, all having Moody's, Fitch's, and S&P's credit ratings of Aa3, A+, and A+, respectively, or better. The credit ratings of the counterparties for the swap agreements are summarized in Table 19.

Table 19

Schedule of Terms, Fair Values, and Credit Ratings of Swap Agreements
(amounts in thousands)

Swap Termination Date	Outstanding Notional Amount at June 30, 2004	Fair Values at June 30, 2004	Fixed Rate Paid by Electric Power Fund	Variable Rate Received by Electric Power Fund	Counterparty Credit Ratings (Moody's, Fitch's, S&P's)
5/1/2011	$ 94,000	$ (1,000)	2.914 %	67% of LIBOR	Aaa, AAA, AAA
5/1/2012	234,000	(2,000)	3.024	67% of LIBOR	Aaa, AAA, AAA
5/1/2013	200,000	(1,000)	3.405	BMA	Aa3, A+, A+
5/1/2013	100,000	—	3.405	BMA	Aa3, AA-, A+
5/1/2013	30,000	—	3.405	BMA	Aa3, AA-, A+
5/1/2014	194,000	2,000	3.204	67% of LIBOR	Aa1, AA-, AA-
5/1/2015	174,000	(2,000)	3.280	67% of LIBOR	Aaa, AAA, AAA
5/1/2016	202,000	2,000	3.342	67% of LIBOR	Aa2, AA, AA-
5/1/2017	202,000	3,000	3.389	67% of LIBOR	Aa3, AA-, A+
Total	**$ 1,430,000**	**$ 1,000**			

Basis Risk: DWR is exposed to basis risk on the swaps that have payments calculated on the basis of a percentage of LIBOR. The basis risk results from the fact that DWR's floating interest payments payable on the underlying debt are determined in the tax-exempt market, while the DWR floating receipts on the swaps are based on LIBOR, which is determined in the taxable market. Should the relationship between LIBOR and the tax-exempt market change and move to convergence, or should DWR's bonds trade at levels worse (higher in rate) in relation to the tax-exempt market, DWR's cost would increase. As of June 30, 2004, the variable rate on DWR's bonds ranged from 0.68% to 1.33%, while 67% of LIBOR received on the swap was equal to 0.91%.

Termination Risk: DWR's swap agreements do not contain any out-of-the-ordinary termination events that would expose it to significant termination risk. In keeping with market standards, DWR or the counterparty may terminate a swap agreement if the other party fails to perform under the terms of the contract or in the event of a significant loss of creditworthiness by the other party. DWR views the likelihood of such an event to be remote at this time. If a termination were to occur, at the time of the termination DWR would be liable for payment equal to the swap's fair value, if it had a negative fair value at that time. A termination would mean that DWR's underlying floating-rate bonds would no longer be hedged and DWR would be exposed to floating rate risk, unless it entered into a new hedge.

Rollover Risk: Other than termination, there is no rollover risk associated with the swap agreements, because the agreements have termination dates and notional amounts that are tied to equivalent maturity dates and principal amounts of amortizing debt.

E. Discretely Presented Component Unit Variable Rate/Swap Disclosure – University of California

Table 18 includes debt service requirements and net swap payments as of June 30, 2004, of the University of California (UC), a discretely presented component unit. Total principal, variable interest, and interest rate net swap payments are $346 million, $47 million, and $103 million, respectively.

Objective: UC has entered into interest rate swap agreements as a means to lower borrowing costs, compared to fixed-rate bonds at the time of issuance, and to effectively change the variable interest rate on bonds to a fixed rate of 3.1%. The swaps are with three financial institutions in connection with variable-rate refunding revenue bonds associated with the UC Davis Medical Center.

Terms: The bonds and related swap agreements mature on September 1, 2026. The aggregate notional amount of swaps matches the outstanding amounts on the bonds throughout the term of the bonds. UC pays the swap counterparties a fixed payment of 3.1% and receives a variable payment computed as 67% of the 30-day LIBOR. UC believes that, over time, the variable interest rates it pays on the bonds will approximate the variable payments it receives on the interest rate swaps, leaving the fixed interest rate payment on the swaps as the net payment obligation for the transaction.

Fair Value: The swaps have an estimated positive fair value of $12.4 million as of June 30, 2004, because interest rates have increased since the execution of the swaps. The fair value is an indication of the difference in value of the swap fixed-interest payments due and the fixed-rate payments due on a swap with identical terms executed on June 30, 2004. The fair value of the interest rate swap is the estimated amount the UC would have received if the swap agreement had been terminated on June 30, 2004. The fair value was estimated by the financial institutions using available quoted market prices or a forecast of expected discounted future cash flows.

Basis Risk: UC is exposed to basis risk whenever the interest rates on the bonds are reset. The interest rates on the bonds are tax-exempt interest rates reset each 28 days, weekly or daily, while the variable receipt rate on the interest rate swaps is taxable (67% of the 30-day LIBOR).

Termination and Interest Rate Risk: UC is exposed to losses in the event of nonperformance by counterparties or unfavorable interest rate movements. The swap may be terminated if the insurer's credit quality rating falls below A- as issued by Fitch Ratings or Standard & Poor's, thereby canceling the synthetic interest rate and returning the interest rate payments to the variable interest rates on the bonds. At termination, UC may also owe a termination payment if there is a realized loss on the fair value of the swap.

F. Discretely Presented Component Unit Variable Rate/Swap Disclosure – California Housing Finance Agency

Table 18 includes debt service requirements and net swap payments as of June 30, 2004, for the California Housing Finance Agency (CalHFA), a discretely presented component unit. Total principal, variable interest, and interest rate net swap payments are $4.1 billion, $540 million, and $1.7 billion, respectively.

Objective: CalHFA has entered into interest rate swap agreements with various counterparties to protect itself against rising rates by providing a synthetic fixed rate for a like amount of variable-rate bond obligations. The majority of CalHFA's interest rate swap transactions are structured to pay a fixed rate of interest while receiving a variable rate of interest, with some exceptions. CalHFA previously entered into swaps at a ratio of 65% of LIBOR. Its current formula (60% of LIBOR plus a spread, currently .26%) results in comparable fixed-rate economics but performs better when short-term rates are low and the BMA/LIBOR percentage is high.

CaLHFA has used this new formula since December 2002, and it expects to continue to use this formula for LIBOR-based swaps exclusively. In addition, CalHFA entered into 13 basis swaps as a means to change the variable-rate formula received from counterparties for $692 million outstanding notational amount from 65% of LIBOR to varying floating rates.

Terms, Fair Value, and Credit Risk: Most of CalHFA's notional amounts of the swaps match the principal amounts of the associated debt. CalHFA has created a synthetic fixed rate by swapping a portion of its variable rate debt. CalHFA did not pay or receive any cash when the swap transactions were initiated. CalHFA utilizes ten counterparties for its interest rate swap transactions. Counterparties are required to collateralize their exposure to CalHFA when their credit ratings fall from AA to the highest single-A category, A1/A+. CalHFA is not required to provide collateralization until its ratings fall to the mid-single-A category, A2/A. CalHFA's swap portfolio has an aggregate negative fair value, due to a decline in interest rates, of $187 million as of June 30, 2004. Fair values are as reported by CalHFA's counterparties and are estimated using the zero-coupon method. Since CalHFA's swap portfolio has an aggregate negative fair value, CalHFA is not exposed to credit risk. However, if interest rates rise the negative fair value of the swap portfolio would be reduced and could eventually become positive. At this point, CalHFA would become exposed to the counterparties' credit, due to the counterparties would be obligated to make payments to CalHFA in the event of termination. CalHFA has 97 swap transactions, with outstanding notional amounts of $4.1 billion. Standard & Poor's credit ratings for these counterparties range from A+ to AAA; Moody's credit ratings range from Aa3 to Aaa.

Basis Risk: CalHFA's swaps contain the risk that the floating-rate component of the swap will not match the floating rate of the underlying bonds. This risk arises because floating rates paid by swap counterparties are based on indices that consist of market-wide averages, while interest paid on CalHFA's variable-rate bonds is specific to individual issues. CalHFA's variable-rate tax-exempt bonds trade at a slight discount to the BMA index. Swaps associated with tax-exempt bonds, for which CalHFA receives a variable-rate payment, are based on a percentage of LIBOR; thus, CalHFA is exposed to basis risk if the relationship between BMA and LIBOR converges. As of June 30, 2004, the BMA rate was 1.05%, 65% of the one-month LIBOR was 0.89%, and 60% of the one-month LIBOR plus 26 basis points was 1.08%.

Termination Risk: Counterparties to CalHFA's interest rate swaps have termination rights that require settlement payments by either CalHFA or the counterparties, based on the fair value of the swap. As of June 30, 2004, no termination events had occurred.

Rollover Risk: CalHFA's swap agreements have limited rollover risk because the agreements contain scheduled reductions to outstanding notional amounts that are expected to follow scheduled and anticipated reductions in the associated bonds payable. Twenty-eight swap agreements contain par termination rights to accommodate unexpected faster paydown of the associated bonds from higher rates of prepayments of the home ownership loan portfolio.

G. Revenue Bond Defeasances

1. Current Year

In March 2004, the primary government issued $190 million in Central Valley Project Water System Revenue Bonds, of which a portion of the proceeds were used to refund $94 million of outstanding bonds. The current refunding resulted in the recognition of an accounting loss of approximately $2.6 million for the 2003-04 fiscal year. The primary government used the issuance of the Series AB bonds to provide debt service savings of more than $13.8 million. This smoothing of the primary government's debt service payments resulted in higher debt service payments in some years but, given the lower expected interest cost of the auction rate bonds, the financing is projected to generate present value savings of nearly $4 million.

During the year ended June 30, 2004, the primary government issued $280 million in lease revenue bonds to refund $297 million in lease revenue bonds. The net proceeds after discount, insurance, and other bond issuance costs is to provide for all future debt service payments. The advance refunding reduces aggregate debt service payments by $55 million over the next 15-17 years and resulted in an economic gain of $42 million to be recognized over this period.

In December 2003, CalHFA, a discretely presented component unit, issued Multifamily Housing Revenue Bonds. On February 2, 2004, a portion of the proceeds was used to refund Multi-Unit Rental Housing Revenue Bonds. The loss from the debt refunding was deferred and will be amortized as a component of interest expense over the shorter of the term of bonds extinguished or the term of the refunding bonds. The refunding will decrease the debt service cash outflow for Multifamily Programs by approximately $4 million. The refunding may also provide for an estimated economic gain of approximately $2 million for the Multifamily Programs.

In September 2003, UC, a discretely presented component unit, issued Multiple Revenue Bonds, of which a portion of the proceeds was used to refund $409 million of outstanding Multiple Purpose Projects Revenue Bonds, $180 million of Housing System Revenue Bonds, and $34 million of Research Facilities Revenue Bonds. The refunding resulted in deferred financing costs of $15 million, which will be amortized as interest expense over the next 33 years, the term of the bonds. Aggregate debt service payments were increased by $74 million over the term of the bonds due to the extension of maturities for certain projects; however, the University was able to obtain an economic gain of $22 million.

In November 2003, UC issued $386 million of General Revenue Bonds to refund $408 million of outstanding Multiple Purpose Projects Revenue Bonds. The refunding resulted in deferred financing costs of $8 million, which will be amortized as interest expense over the next 25 years, the term of the bonds. Aggregate debt service payments were decreased by $51 million over the term of the bonds and the University was able to obtain an economic gain of $19 million.

In May 2004, UC issued Hospital Revenue Bonds, of which a portion of the proceeds was used to refund $98 million of outstanding bonds. The refunding resulted in deferred financing costs of $2 million, which will be amortized as a reduction to interest expense over the next 35 years, the term of the bonds. Aggregate debt service payments were increased by $3 million over the term of the bonds due to the extension of maturities for certain projects; however, UC was able to obtain an economic gain of $5 million.

2. Prior Years

In prior years, the primary government defeased certain bonds by placing the proceeds of new bonds in irrevocable trust accounts to provide for all future debt service requirements. Accordingly, the assets and liabilities for these defeased bonds are not included in the financial statements. As of June 30, 2004, the outstanding balance of revenue bonds defeased in prior years was approximately $705 million.

In prior years, the University of California, a discretely presented component unit, defeased certain bonds. Investments that have maturities and interest rates sufficient to fund retirement of defeased liabilities are being held in irrevocable trusts for the debt service payments. Accordingly, the assets of the trust accounts and the liabilities for the defeased bonds are not included in the State's financial statements. As of June 30, 2004, the outstanding balance of University of California revenue bonds defeased in prior years was $306 million.

NOTE 17: INTERFUND BALANCES AND TRANSFERS

A. Interfund Balances

Due from other funds and due to other funds represent short-term interfund receivables and payables resulting from the time lag between the dates that goods and services are provided and received and the dates that payments between entities are made. Table 20 presents the amounts due from and due to other funds.

Table 20

Schedule of Due From Other Funds and Due To Other Funds
June 30, 2004
(amounts in thousands)

	Due To					
Due From	**General Fund**	**Federal Fund**	**Transportation Construction Fund**	**Nonmajor Governmental Funds**	**Electric Power Fund**	**Water Resources Fund**
Governmental funds						
General Fund	$ —	$ —	$ 92,238	$ 54,313	$ —	$ —
Federal Fund	421,815	—	1,017,759	427,435	—	—
Transportation Construction Fund	—	—	—	149,581	—	—
Nonmajor governmental funds	292,782	—	20,856	242,559	—	—
Total governmental funds	**714,597**	**—**	**1,130,853**	**873,888**	**—**	**—**
Enterprise funds						
Water Resources Fund	—	—	—	—	—	—
Public Building Construction Fund	10,131	—	—	—	—	—
State Lottery Fund	—	—	—	238,493	—	—
Unemployment Programs Fund	36,279	—	—	69,738	—	—
Nonmajor enterprise funds	45,003	—	29,031	125	—	—
Total enterprise funds	**91,413**	**—**	**29,031**	**308,356**	**—**	**—**
Internal service funds	**6,166**	**67**	**41,173**	**79,183**	**15,000**	**1,761**
Fiduciary funds	**15,319**	**—**	**—**	**31**	**—**	**—**
Total primary government	**$ 827,495**	**$ 67**	**$ 1,201,057**	**$ 1,261,458**	**$ 15,000**	**$ 1,761**

Due To						
Public Building Construction Fund	**State Lottery Fund**	**Unemployment Programs Fund**	**Nonmajor Enterprise Funds**	**Internal Service Funds**	**Fiduciary Funds**	**Total**
$ —	$ 2,266	$ —	$ 19	$ 135,459	$ 3,076,114	$ 3,360,409
—	—	4,563	—	2,986	3,355,048	5,229,606
—	—	—	—	1,828	—	151,409
247	—	—	289	18,198	70,228	645,159
247	**2,266**	**4,563**	**308**	**158,471**	**6,501,390**	**9,386,583**
—	—	—	—	34,640	—	34,640
—	—	—	—	45,108	4,434	59,673
—	—	—	—	—	—	238,493
—	—	—	—	—	—	106,017
—	—	—	—	145	27	74,331
—	**—**	**—**	**—**	**79,893**	**4,461**	**513,154**
11,401	**—**	**4,792**	**4,783**	**52,493**	**8,119**	**224,938**
—	**—**	**—**	**—**	**1,265**	**383**	**16,998**
$ 11,648	**$ 2,266**	**$ 9,355**	**$ 5,091**	**$ 292,122**	**$ 6,514,353**	**$ 10,141,673**

Interfund receivables and payables are the result of interfund loans that are not expected to be repaid within one year. The $2.4 billion in nonmajor governmental funds payable from the General Fund is primarily the result of legislation authorizing the transfer of cash from special revenue funds to the General Fund. Table 21 presents the interfund receivables and payables.

Table 21

Schedule of Interfund Receivables and Payables
June 30, 2004
(amounts in thousands)

	Interfund Payables						
Interfund Receivables	**General Fund**	**Transportation Construction Fund**	**Nonmajor Governmental Funds**	**Water Resources Fund**	**Nonmajor Enterprise Funds**	**Fiduciary Funds**	**Total**
Governmental funds							
General Fund	$ —	$ —	$ 2,410,277	$ —	$ 7,100	$ 880,226	$ 3,297,603
Nonmajor governmental funds	13,849	648,900	—	—	—	—	662,749
Total governmental funds	**13,849**	**648,900**	**2,410,277**	**—**	**7,100**	**880,226**	**3,960,352**
Enterprise funds	**1,348**	**—**	**—**	**—**	**2,399**	**—**	**3,747**
Internal service funds	**3,000**	**—**	**3,158**	**91,516**	**—**	**—**	**97,674**
Fiduciary funds	**23,431**	**—**	**—**	**—**	**—**	**—**	**23,431**
Total primary government	**$ 41,628**	**$ 648,900**	**$ 2,413,435**	**$ 91,516**	**$ 9,499**	**$ 880,226**	**$ 4,085,204**

Due from primary government and due to component units represent short-term receivables and payables between the primary government and component units resulting from the time lag between the dates that goods and services are provided and received and the dates that payments between entities are made. Table 22 presents the due from primary government and due to component units.

Table 22

Schedule of Due From Primary Government and Due To Component Units
June 30, 2004
(amounts in thousands)

	Due To		
Due From	**University of California**	**Nonmajor Component Units**	**Total**
Governmental funds			
General Fund	$ 113,759	$ —	$ 113,759
Nonmajor governmental funds	73,011	2	73,013
Total governmental funds	**186,770**	**2**	**186,772**
Internal service funds	**—**	**2,028**	**2,028**
Total primary government	**$ 186,770**	**$ 2,030**	**$ 188,800**

B. Interfund Transfers

As required by law, transfers move money collected by one fund to another fund that does the disbursing. The General Fund and certain other funds transfer money to support various programs accounted for in other funds. The largest transfers from the General Fund to the nonmajor governmental funds were $1.1 billion for the support of trial courts and $1.1 billion to replace the reduction in the vehicle license fees used to support local governments. The $972 million transfer from the Federal Fund to the nonmajor governmental funds was for the administration of the unemployment programs. The largest transfers from the nonmajor governmental funds to the General Fund were $11.3 billion from the Economic Recovery Fund and $2.3 billion from the Golden State Tobacco Securitization Corporation to support General Fund programs. Table 23 presents interfund transfers of the primary government.

Table 23

Schedule of Interfund Transfers
June 30, 2004
(amounts in thousands)

	Transferred To		
Transferred From	**General Fund**	**Transportation Construction Fund**	**Nonmajor Governmental Funds**
Governmental funds			
General Fund	$ —	$ —	$ 3,216,073
Federal Fund	—	—	971,781
Transportation Construction Fund	—	—	14,760
Nonmajor governmental funds	13,930,752	868	264,381
Total governmental funds	**13,930,752**	**868**	**4,466,995**
Enterprise funds			
Nonmajor enterprise funds	48,980	—	8,844
Total enterprise funds	**48,980**	**—**	**8,844**
Internal service funds	**3,677**	**14,916**	**—**
Total primary government	**$ 13,983,409**	**$ 15,784**	**$ 4,475,839**

Transferred To				
Unemployment Programs Fund	**Public Building Construction Fund**	**Nonmajor Enterprise Funds**	**Fiduciary Funds**	**Total**
$ —	$ —	$ —	$ 4,226	$ 3,220,299
14,017	—	—	—	985,798
—	—	—	—	14,760
—	147	10,695	864	14,207,707
14,017	**147**	**10,695**	**5,090**	**18,428,564**
—	—	8,765	—	66,589
—	**—**	**8,765**	**—**	**66,589**
—	**—**	**—**	**—**	**18,593**
$ 14,017	**$ 147**	**$ 19,460**	**$ 5,090**	**$ 18,513,746**

NOTE 18: FUND DEFICITS AND ENDOWMENTS

A. Fund Deficits

Table 24 shows the funds that had deficits.

Table 24

Schedule of Fund Deficits
June 30, 2004
(amounts in thousands)

	Governmental Funds	Internal Service Funds	Component Units
General Fund	$ 1,540,700	$ —	$ —
Prison Construction Fund	4,571	—	—
Higher Education Construction Fund	203,345	—	—
Architecture Revolving Fund	—	11,167	—
Water Resources Revolving Fund	—	10,013	—
California School Finance Authority	—	—	52
California Consumer Power and Conservation Financing Authority	—	—	1,741
Total	**$ 1,748,616**	**$ 21,180**	**$ 1,793**

B. Discretely Presented Component Unit Endowments

The University of California, a discretely presented component unit, administers certain restricted nonexpendable, restricted expendable, and unrestricted endowments that are included in the related net asset categories of the government-wide and fund financial statements. As of June 30, 2004, the total fair value of restricted and unrestricted endowments was $3.7 billion and $1.0 billion, respectively. The university's policy is to retain appreciation on investments with the endowment after an annual income distribution. Endowment income capitalized to endowment principal that is available to meet future funding needs upon approval by the board of regents amounted to $1.3 billion at June 30, 2004. The portion of investment returns earned on endowments and distributed each year to support current operations is based on a rate approved by the board of regents.

NOTE 19: RISK MANAGEMENT

The primary government has elected, with a few exceptions, to be self-insured against loss or liability. Generally, the exceptions are when a bond resolution or a contract requires the primary government to purchase commercial insurance for coverage against property loss or liability. There have been no significant reductions in insurance coverage from the prior year. In addition, there has been no insurance settlement in the last three years that has exceeded insurance coverage. The primary government generally does not maintain reserves. Losses are covered in the year in which the payment occurs by appropriations from each fund responsible for payment. All claim payments are on a “pay as you go” basis, with workers’ compensation benefits for self-insured agencies being initially paid by the State Compensation Insurance Fund. The potential amount of loss arising from risks other than workers’ compensation benefits is not considered material in relation to the primary government’s financial position.

The discounted liability for unpaid self-insured workers' compensation losses is estimated to be $2.7 billion as of June 30, 2004. This estimate is based on actuarial reviews of the State's employee workers' compensation program and includes indemnity payments to claimants, as well as all other costs of providing workers' compensation benefits, such as medical care and rehabilitation. The estimate also includes the liability for unpaid services fees, industrial disability leave benefits, and incurred but not reported amounts. The estimated total liability of approximately $3.7 billion is discounted to $2.7 billion, using a 4% interest rate. Of the total, $362 million is a current liability, of which $265 million is included in the General Fund, $96 million in the special revenue funds, and $1 million in the internal service funds. The remaining $2.4 billion is reported as other noncurrent liabilities in the government-wide Statement of Net Assets. Changes in claims liabilities during the year ended June 30 are shown in Table 25.

The University of California, a discretely presented component unit, is self-insured for medical malpractice, workers' compensation, employee health care, and general liability claims. These risks are subject to various claim and aggregate limits, with excess liability coverage provided by an independent insurer. Liabilities are recorded when it is probable that a loss has occurred and the amount of the loss can be reasonably estimated. These losses include an estimate for claims that have been incurred but not reported. The estimated liabilities are based upon an independent actuarial determination of the anticipated future payments, discounted at rates ranging from 4.5% to 6.5%. The other discretely presented component units do not have significant liabilities related to self-insurance. Changes in self-insurance claims liabilities for the primary government and the University of California are shown in Table 25.

Table 25

Schedule of Changes in Self-Insurance Claims
Years Ended June 30
(amounts in thousands)

	Primary Government		University of California – Discretely Presented Component Unit	
	2004	2003	2004	2003
Unpaid claims, beginning	$ 2,828,010	$ 1,931,000	$ 520,177	$ 453,800
Incurred claims	298,978	1,298,184	289,247	299,079
Claim payments	(402,153)	(401,174)	(242,462)	(232,702)
Unpaid claims, ending	**$ 2,724,835**	**$ 2,828,010**	**$ 566,962**	**$ 520,177**

NOTE 20: NONMAJOR ENTERPRISE SEGMENT INFORMATION

A segment is an identifiable activity reported as or within an enterprise fund or another stand-alone entity for which debt is outstanding and a revenue stream has been pledged in support of that debt. In addition, to qualify as a segment, an activity must be subject to an external requirement to separately account for revenues, expenses, gains and losses, assets, and liabilities of the activity. All of the activities reported in the following condensed financial information meet these requirements.

Table 26 presents the Condensed Statement of Net Assets, the Condensed Statement of Revenues, Expenses, and Changes in Fund Net Assets, and the Condensed Statement of Cash Flows for nonmajor enterprise funds that meet the definition of a segment. The primary sources of revenues for these funds follow.

High Technology Education Fund: Rental payments on public buildings which are used for educational and research purposes related to specific fields of high technology.

State University Dormitory Building Maintenance and Equipment Fund: Charges to students for housing and parking, and student fees for campus unions.

State Water Pollution Control Revolving Fund: Interest charged on loans to communities for construction of water pollution control facilities and projects.

Housing Loan Fund: Interest payments from low interest, long-term farm and home mortgage loan contracts to eligible veterans living in California.

Table 26

Nonmajor Enterprise Segments
(amounts in thousands)

Condensed Statement of Net Assets
June 30, 2004

	High Technology Education	State University Dormitory Building Maintenance and Equipment
Assets		
Due from other funds	$ 201	$ —
Due from other governments	—	—
Other current assets	38,203	599,117
Capital assets	—	1,319,666
Other noncurrent assets	452,010	2,847
Total assets	**$ 490,414**	**$ 1,921,630**
Liabilities		
Due to other funds	$ —	$ 41,947
Due to other governments	—	—
Other current liabilities	35,232	106,833
Noncurrent liabilities	331,252	1,141,060
Total liabilities	**366,484**	**1,289,840**
Net assets		
Investment in capital assets, net of related debt	—	265,094
Restricted	123,930	264,862
Unrestricted	—	101,834
Total net assets	**123,930**	**631,790**
Total liabilities and net assets	**$ 490,414**	**$ 1,921,630**

Condensed Statement of Revenues, Expenses, and Changes in Fund Net Assets
Year Ended June 30, 2004

	High Technology Education	State University Dormitory Building Maintenance and Equipment
Operating revenues	$ 34,052	$ 241,044
Depreciation expense	—	(162,087)
Other operating expenses	(37,261)	(222,077)
Operating income (loss)	(3,209)	(143,120)
Nonoperating revenues (expenses)	—	(32,859)
Capital contributions	—	—
Transfers in	—	8,765
Transfers out	—	(16,061)
Change in net assets	(3,209)	(183,275)
Total net assets, July 1, 2003	**127,139**	**815,065** *
Total net assets, June 30, 2004	**$ 123,930**	**$ 631,790**

Condensed Statement of Cash Flows
Year Ended June 30, 2004

	High Technology Education	State University Dormitory Building Maintenance and Equipment
Net cash provided (used) by:		
Operating activities	$ 35,278	$ 47,212
Noncapital financing activities	—	(29,773)
Capital and related financing activities	(35,865)	(113,834)
Investing activities	—	11,318
Net increase (decrease)	**(587)**	**(85,077)**
Cash and pooled investments at July 1, 2003	**51,426**	**662,909** *
Cash and pooled investments at June 30, 2004	**$ 50,839**	**$ 577,832**

* Restated

State Water Pollution Control	Housing Loan	Total
$ 1,200	$ 2,369	$ 3,770
126,015	—	126,015
330,076	652,607	1,620,003
—	3,398	1,323,064
1,937,677	1,709,993	4,102,527
$ 2,394,968	**$ 2,368,367**	**$ 7,175,379**
$ 734	$ —	$ 42,681
—	866	866
26,058	262,859	430,982
288,384	1,840,434	3,601,130
315,176	**2,104,159**	**4,075,659**
—	3,398	268,492
830,947	260,810	1,480,549
1,248,845	—	1,350,679
2,079,792	**264,208**	**3,099,720**
$ 2,394,968	**$ 2,368,367**	**$ 7,175,379**
$ 46,810	$ 136,429	$ 458,335
—	(980)	(163,067)
(4,059)	(172,649)	(436,046)
42,751	(37,200)	(140,778)
(6,195)	7,376	(31,678)
47,528	—	47,528
—	—	8,765
—	—	(16,061)
84,084	(29,824)	(132,224)
1,995,708	**294,032**	**3,231,944** *
$ 2,079,792	**$ 264,208**	**$ 3,099,720**
$ (144,058)	$ 202,191	$ 140,623
29,420	(451,425)	(451,778)
—	(7)	(149,706)
6,174	106,085	123,577
(108,464)	**(143,156)**	**(337,284)**
438,426	**753,301**	**1,906,062** *
$ 329,962	**$ 610,145**	**$ 1,568,778**

NOTE 21: NO COMMITMENT DEBT

Certain debt of the nonmajor component units is issued to finance activities such as construction of new facilities and remodeling of existing facilities, as well as acquisition of equipment. This debt is collateralized solely by the credit of private and public entities and is administered by trustees independent of the State. As of June 30, 2004, these component units had $15.4 billion of debt outstanding, which is not debt of the State.

The State has also entered into transactions that involve debt issued by four special purpose trusts that were created by one of its nonmajor component units, the California Infrastructure and Economic Development Bank. The special purpose trusts are legally separate entities that issued long-term debt for the primary purpose of financing certain costs of assets and obligations that are recoverable by utilities through electric rate charges. The issuance of long-term debt may prevent the utilities from offering electricity at lower rates in a competitive market. As of June 30, 2004, the special purpose trusts had approximately $2.1 billion of debt outstanding. Like the debt of nonmajor component units, the debt of the special purpose trusts is not debt of the State.

In addition, the State has participated in transactions involving debt issued by the Bay Area Toll Authority, which is not part of the State's reporting entity. The debt was issued to finance improvements to existing bridges and to design and construct new bridges. As of June 30, 2004, the Bay Area Toll Authority had $700 million of debt outstanding, which is not debt of the State.

NOTE 22: CONTINGENT LIABILITIES

A. Litigation

The primary government is a party to numerous legal proceedings, many of which normally occur in governmental operations. To the extent they existed, the following were accrued as a liability in the government-wide financial statements: legal proceedings that were decided against the primary government before June 30, 2004; legal proceedings that were in progress as of June 30, 2004, and were settled or decided against the primary government as of January 28, 2005; and legal proceedings having a high probability of resulting in a decision against the primary government as of January 28, 2005, and for which amounts could be estimated. In the governmental fund financial statements, the portion of the liability that is expected to be paid within the next 12 months is recorded as a liability of the fund from which payment will be made. In the proprietary fund financial statements, the entire liability is recorded in the fund from which payment will be made.

In addition, the primary government is involved in certain other legal proceedings that, if decided against the primary government, may impair its revenue sources or require it to make significant expenditures. Because of the prospective nature of these proceedings, no provision for the potential liability has been made in the financial statements.

Following are the more significant lawsuits pending against the primary government.

The primary government was a defendant in *County of San Diego v. Commission on State Mandates et al.,* regarding certain unreimbursed costs for the care of medically indigent adults (MIAs). In 1997, the California Supreme Court ruled that, by excluding MIAs from Medi-Cal, the State had mandated a new program on the counties. The court sent the matter back to the Commission on State Mandates (commission) to decide whether and by what amount San Diego County had incurred costs not reimbursed by the State. San Diego County later appealed an adverse decision by the commission. On September 24, 2003, in an unpublished decision, the Court of Appeal ruled in favor of San Diego County on certain of its claims and determined that the State owed the county $3 million for medical services rendered to MIAs during 1991 and 1992. The State filed a Petition for Review in the California Supreme Court and, on December 18, 2003, the California Supreme Court denied the State's petition. The commission has taken the position that it would be bound to apply the holding of the San Diego County case to any new claim for prospective relief brought by any county as a "test claim." A test claim filed by the County of San Bernardino (county) regarding certain unreimbursed costs for the care of MIAs is now pending before the commission. In recent years, counties have collectively received approximately $1.0 billion annually in vehicle license fee revenue and $410 million annually in sales tax revenue to fund various public health programs, which include programs that provide services to MIAs; however, the county claims that funding is inadequate to cover all services to MIAs mandated by the State. The county's test claim poses a potential for a negative impact on the General Fund in the amount of the unreimbursed costs for all similarly situated county claimants for a period of years, as determined by the commission. The amount demanded by the county for the 2000-01 fiscal year alone is over $9 million. Certain estimates of the annual cost of services rendered by all counties to MIAs exceed $4.0 billion. It is difficult to determine how much could be recovered by the counties, because each situation is fact-driven and lack of documentation was a major concern in the San Diego case.

The primary government is a defendant in two actions*, County of San Diego v. State of California, et al.,* and *County of Orange v. State of California, et al.,* alleging that the State's practice, in recent years, of (1) failing to appropriate any funds for reimbursement to local governments for state-mandated services or programs and (2) "deferring" payments to local governments for certain state-mandated services and programs by making a budgetary appropriation of $1,000 for each program, to be divided among all 58 counties, violates the State Constitution. These cases were consolidated in San Diego County Superior Court. The plaintiff counties are seeking full payment for the unreimbursed costs of implementing a variety of programs over the last few years. San Diego County has alleged unreimbursed costs in excess of $40 million through the 2003-04 fiscal year for a variety of programs. Orange County has alleged in excess of $116 million for unreimbursed state-mandated costs. A final determination by an appellate court that the contested appropriation practices are unconstitutional or that the State is required to appropriate an amount equal to the amount of the mandated costs, if applied to each of California's 58 counties, could result in costs exceeding $1.5 billion for existing unreimbursed mandates.

A hearing on the counties' motion for judgment on the pleadings was held on October 15, 2004. At the hearing, the judge requested additional briefing on the impact that Proposition 1A would have on the case. The judge granted the counties' motion only as to limited declaratory relief, concluding only that the $1,000 appropriation for state-mandated programs, with payment of the balance deferred to the future, violated the State's obligation to reimburse local governments for their state-mandated costs. The judge denied the remainder of the motion, essentially finding that he did not have the authority to order the State to provide the claimed reimbursement absent identification by the plaintiff of a reasonably available appropriation for that purpose. Based upon the court's ruling on the counties' motion for judgment on the pleadings, a trial court order requiring immediate payment of the counties' claims appears unlikely. However, it is likely that reimbursement of some significant amounts, although not necessarily the full amount sought, will be made during the five-year period beginning in the 2006-07 fiscal year.

The primary government is a party in several lawsuits which allege that the gross receipts from the plaintiffs' sale of certain short-term financial instruments constitute business income and therefore must be included in the denominator of the California sales factor of the apportionment formula to be applied to the business income of the plaintiffs. The plaintiffs further contend that the exclusion is a violation of their rights under the due process and commerce clauses of the U.S. Constitution. The Franchise Tax Board (board) maintains that, under pertinent tax statutes, the return of the original loan proceeds from a maturing debt instrument is not a "gross receipt" for sales factor purposes and thus must be excluded from the denominator of the sales factor. The board estimates that the amount at issue to all taxpayers for prior years could exceed $500 million. The lead case in this issue is currently being reviewed in the California Supreme Court. The other five cases are on hold and are pending the lead case decision. In addition, one taxpayer is claiming that the board improperly excluded value-added taxes from the denominator of the sales factor and should have valued property for purposes of the property factor of the apportionment formula at current fair market value rather than historical cost.

The primary government is party to 27 separate actions involving approximately 3,000 plaintiffs regarding flood litigation. These cases arose out of the February 20, 1986, breach of the south levee of the Yuba River. A tentative agreement has been reached to settle all plaintiffs' cases for the sum of $464 million. The potential for an unfavorable outcome is a certainty, so the State has accrued a long-term obligation for this amount in the government-wide financial statements. The 2005-06 *Governor's Budget* proposes funding to satisfy this obligation.

The primary government is a defendant in litigation related to major flooding in six geographical areas of northern California that resulted in significant property damage and destruction. The case involves approximately 600 plaintiffs in Yuba County. This case has been settled for $47 million, with the State agreeing to pay $45 million. The State has accrued a long-term obligation for $45 million in the government-wide financial statements. The 2005-06 *Governor's Budget* proposes funding to satisfy this obligation.

The primary government is a defendant in an action, *Sanchez, et al., v. Johnson, et al.,* where a class of persons with developmental disabilities is seeking injunctive relief against the Health and Human Services Agency and the departments of Developmental Services, Mental Health, and Finance, to obtain higher funding rates for service providers. If the rates requested by the plaintiffs are awarded, costs to the State will increase by approximately $1.0 billion per year.

The primary government is a party to the lawsuit of *Alan J. Titus and Marjorie Goldman v. County of Marin,* an action related to property taxation. Propositions 13 and 8 limit property tax to 1% of a property's base year value, which is essentially the acquisition value. This base year value can be increased by not more than 2% per annum but may be reduced by any amount to reflect loss of value. The plaintiffs contend that the common assessor practice whereby value is brought back up after a temporary reduction without regard to the 2% limitation is unconstitutional. The trial court ruled against taxpayers Titus and Goldman, who appealed. The California Attorney General filed an amicus curiae brief on behalf of the Department of Finance, supporting Marin County's real property assessment approach. The matter was argued before the First District Court of Appeal on December 13, 2004, and the court issued a favorable ruling for the county on January 14, 2005. The exposure to Marin County is approximately $100 million, meaning a total exposure to all counties of over $10 billion, of which the State would have to "backfill" some $4-5 billion due to Proposition 98 education and other state funding requirements.

The University of California (UC), the State Compensation Insurance Fund (SCIF), the California Housing Finance Agency (CalHFA), and nonmajor discretely presented component units are contingently liable in connection with claims and contracts, including those currently in litigation, arising in the normal course of their activities. Although there are inherent uncertainties in any litigation, the management and the general counsel of UC, SCIF, and CalHFA are of the opinion that the outcome of such matters either is not expected to have a material effect on the financial statements or cannot be estimated at this time.

B. Federal Audit Exceptions

The primary government receives substantial funding from the federal government in the form of grants and other federal assistance. The primary government, UC, and CalHFA are entitled to these resources only if they comply with the terms and conditions of the grants and contracts and with the applicable federal laws and regulations; they may spend these resources only for eligible purposes. If audits disclose exceptions, the primary government, UC, and CalHFA may incur a liability to the federal government.

NOTE 23: PENSION TRUSTS

Three retirement systems, the California Public Employees' Retirement System (CalPERS), the California State Teachers' Retirement System (CalSTRS), and the University of California Retirement System, all of which are fiduciary component units, are included in the pension and other employee benefit trust funds column of the fiduciary funds and similar component units' financial statements. The pension liability for all pension and other employee benefit trust funds was determined in accordance with GASB Statement No. 27, *Accounting for Pensions by State and Local Government Employers*. The amounts of the pension liability for all pension and other employee benefit trust funds are presented in Table 28 as the net pension obligation (NPO) as of June 30, 2004. The investments of these fiduciary component units are included in the primary government investments presented in Table 1 in Note 3, Deposits and Investments.

CalPERS administers five defined benefit retirement plans: the Public Employees' Retirement Fund (PERF), the Judges' Retirement Fund (JRF), the Judges' Retirement Fund II (JRF II), the Legislators' Retirement Fund (LRF), and the Volunteer Firefighters' Length of Service Award Fund (VFF). CalPERS also administers three defined contribution plans: the State Peace Officers' and Firefighters' Defined Contribution Plan Fund (SPOFF), the public employee Replacement Benefit Fund (RBF), and the public employee Supplemental Contributions Program Fund (SCPF). CalPERS issues a publicly available financial report that includes financial statements and required supplementary information for these plans. This report may be obtained by writing to the California Public Employees' Retirement System, Fiscal Services Division, P.O. Box 942703, Sacramento, California 94229.

CalPERS uses the accrual basis of accounting. Member contributions are recognized when due. The VFF, the SPOFF, and the RBF are funded only by employer contributions that are recorded when due, and the employer has made a formal commitment to provide the contributions. Benefits under the defined benefit plans and refunds are recognized when due, in accordance with the terms of each plan.

CalSTRS administers three defined benefit retirement plans within the State Teachers' Retirement Plan: the Defined Benefit Program (DB Program), the Defined Benefit Supplement Program, and the Cash Balance Benefit Program. CalSTRS also offers, through a third-party administrator, a defined contribution plan that meets the requirements of Internal Revenue Code Section 403(b). The Teachers' Health Benefits Fund provides post-employment health benefits to retired members of the DB Program. CalSTRS issues a publicly available financial report that includes financial statements and required supplementary information for these plans. This report may be obtained from the California State Teachers' Retirement System, P.O. Box 15275, Sacramento, California 95851.

CalSTRS uses the accrual basis of accounting. Member contributions are recognized in the period in which the contributions are due. Employer and primary government contributions are recognized when due, and the employer or the primary government has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable, in accordance with the retirement and benefits programs.

A. Public Employees' Retirement Fund

1. Fund Information

Plan Description: CalPERS administers the PERF, which is an agent multiple-employer defined benefit retirement plan. Employers participating in the PERF include the primary government and certain discretely presented component units, 61 school employers, and 1,443 public agencies as of June 30, 2004. For reporting purposes, the financial information of the RBF is combined with that of the PERF.

The amount by which the actuarial accrued liability exceeded the actuarial value of assets in the PERF for the primary government and other participating agencies was $22.3 billion at June 30, 2003. This is a result of the difference between the actuarial value of assets of $158.6 billion and the actuarial accrued liability of $180.9 billion. Contributions are actuarially determined.

2. Employer's Information

Plan Description: The primary government and certain discretely presented component units contribute to the PERF. CalPERS acts as a common investment and administrative agent of the primary government and the other member agencies. The discretely presented component units' participation in the PERF is not a material portion of the program. The primary government employees served by the PERF include: first-tier and second-tier miscellaneous and industrial, California Highway Patrol, peace officers and firefighters, and other safety members. The payroll for primary government employees covered by the PERF in the year ended June 30, 2004, was approximately $12.7 billion.

All employees who work half-time or more are eligible to participate in the PERF. The PERF provides benefits based on members' years of service, age, final compensation, and benefit formula. Vesting occurs after five years, or after ten years for second-tier employees. The PERF provides death, disability, and survivor benefits. The benefit provisions are established by statute.

Funding Policy: Benefits are funded by contributions from members and the primary government and earnings from investments. Member and primary government contributions are a percentage of applicable member compensation. Member rates are defined by law and based on the primary government's benefit formula. The primary government contribution rates are determined by periodic actuarial valuations.

Employees, with the exception of employees in the second-tier plans, contribute to the fund based on the required contribution rates. The contribution rates of active plan members are based on a percentage of salary over a monthly base compensation amount of $133 to $863. Employees' required contributions vary from 0.0% to 8.0% of their salary over the base compensation amount. However, for the 2002-03 and 2003-04 fiscal years, first-tier employees were not required to contribute. Specifically, the State of California, pursuant to a memorandum of understanding with the employee unions, agreed to a temporary cessation of employee retirement contributions for the 2002-03 and 2003-04 fiscal years for miscellaneous and industrial employees. As a result, the contribution rates were reduced from the usual statutory 5% or 6% to 0%.

All of the primary government employees served by the PERF are now covered by group term life insurance. The required employer contribution rates for the primary government, without group term life insurance benefits, are shown in Table 27.

Table 27

Schedule of Required Employer Contribution Rates for the Primary Government by Member Category

Year Ended June 30, 2004

	Normal Cost	Unfunded Liability	Group Term Life Benefit	Total Rate
Miscellaneous members				
First tier	10.592 %	4.184 %	0.067 %	14.843 %
Second tier	6.014	4.184	0.067	10.265
Industrial (first and second tier)	10.978	0.076	0.045	11.099
California Highway Patrol	17.117	15.536	0.000	32.653
Peace officers and firefighters	17.285	2.967	0.073	20.325
Other safety members	17.667	4.129	0.134	21.930

For the year ended June 30, 2004, the annual pension cost (APC) and the amount of contributions made by the primary government were each $2.1 billion. The APC and the percentage of APC contributed for the last three years are shown in Table 28. Actuarial valuations of the PERF are performed annually. Information from the last valuation, which was performed as of June 30, 2003, is also shown in Table 28 for the primary government.

B. Judges' Retirement Fund

Plan Description: CalPERS administers the JRF, which is an agent multiple-employer defined benefit retirement plan. The JRF membership includes justices of the Supreme Court and courts of appeal, as well as judges of superior courts, appointed or elected prior to November 9, 1994. There are 59 employers participating in the JRF for the year ended June 30, 2004. The payroll for employees covered by the JRF for the year ended June 30, 2004, was approximately $134 million. The primary government pays the employer contributions for all employees covered by the JRF.

The JRF provides benefits based on a member's years of service, age, final compensation, and benefit formula. Vesting occurs after five years. The JRF provides death, disability, and survivor benefits. Benefits for the JRF are established by the Judges' Retirement Law.

Funding Policy: The contribution rate of active plan members is defined by law and is based on a percentage of salary over a base compensation amount. For the year ended June 30, 2004, the required member rate for the JRF was 8.0%.

The contributions of the primary government to the JRF are not actuarially determined. Contributions are determined by state statute. As of June 30, 2004, employer contributions are required to be 8.0% of applicable member compensation. Other funding to meet benefit payment requirements of the JRF is currently provided by: filing fees, which require varying amounts, depending on fee rate and number of filings; investments, which earn the current yield on short-term investments; and the primary government's balancing contributions, as required by the Judges' Retirement Law. The balancing contributions are an amount at least equal to the estimated benefits payable during the ensuing fiscal year, less the sum of the estimated member contributions during the ensuing fiscal year and net assets available for benefits at the beginning of the fiscal year ("pay as you go" basis).

The annual pension cost (APC) and the amount of employer contributions made to the JRF for the year ended June 30, 2004, were $191 million and $107 million, respectively. The net pension obligation (NPO) of the JRF at June 30, 2004, was $1.1 billion, an increase of $82 million over last year's balance of $987 million. The APC is comprised of $194 million for the annual required contribution (ARC), $74 million for interest on the NPO, and $77 million for the adjustment to the ARC. An actuarial valuation of the JRF's assets and liabilities is made annually. The APC, the percentage of APC contributed, and the NPO for the last three years are shown in Table 28. Information on the last valuation, which was performed as of June 30, 2003, is shown in Table 28. The aggregate cost method that was used for the June 30, 2003, valuation does not identify or separately amortize the unfunded actuarial accrued liability; therefore, this liability is not shown in Table 28.

C. Judges' Retirement Fund II

Plan Description: CalPERS administers the JRF II, which is an agent multiple-employer defined benefit retirement plan. The membership of the JRF II includes justices of the same courts covered by the JRF who were appointed or elected on or subsequent to November 9, 1994. There are 59 employers participating in the JRF II. The payroll for employees covered by the JRF II for the year ended June 30, 2004, was approximately $97 million. The primary government pays the employer contributions for all employees covered by the JRF II.

The JRF II provides benefits based on a member's years of service, age, final compensation, and benefit formula. Vesting occurs after five years. The JRF II provides death, disability, and survivor benefits. Benefits for the JRF II are established by the Judges' Retirement System II Law.

Funding Policy: The required contribution rate of active plan members is defined by law and is based on a percentage of salary over a base compensation amount. For the year ended June 30, 2004, the required member rate for the JRF II was 8.0%, and the primary government's contribution rate for the JRF II was 19.22% of applicable member compensation.

Actuarial valuations for the JRF II are required to be carried out annually. The legislated primary government contribution rate is adjusted periodically as part of the annual Budget Act, in order to maintain or restore the actuarial soundness of the fund.

For the year ended June 30, 2004, the annual pension cost (APC) and the amount of contributions made for the JRF II were approximately $18 million. The APC and the percentage of APC contributed for the year ended June 30, 2004, are shown in Table 28. Information on the last valuation, which was performed as of June 30, 2003, is also shown in Table 28.

D. Legislators' Retirement Fund

Plan Description: CalPERS administers the LRF, which is a single-employer defined benefit retirement plan. The eligible membership of the LRF includes state legislators serving in the legislature prior to November 1, 1990, constitutional officers, and legislative statutory officers. The payroll for the employees covered by the LRF for the year ended June 30, 2004, was approximately $2 million.

The LRF provides benefits based on a member's years of service, age, final compensation, and benefit formula. Vesting occurs after five years. The plan provides death, disability, and survivor benefits. Benefits for the LRF are established by the Legislators' Retirement Law.

The LRF is currently in transition. The number of legislators eligible to participate in the LRF is declining as incumbent legislators leave office and are replaced by new legislators who are not eligible to participate in the program. Eventually, the only active members in the LRF will be approximately 16 constitutional officers (including the Insurance Commissioner and members of the Board of Equalization) and approximately 4 legislative statutory officers.

Funding Policy: The employer contribution requirements of the LRF are based on actuarially determined rates. An actuarial valuation of the LRF's assets and liabilities is required at least every two years. Member contribution rates are defined by law. For the year ended June 30, 2004, contributions made by employees were not required because the plan was superfunded. By definition, "superfunded" is when the plan's actuarial value of assets exceeds the present value of future benefits for current members. However, some members made contributions towards military service and prior service.

The net pension obligation (NPO) of the LRF on June 30, 2004, was approximately $10 million. There was no annual pension cost (APC) because the annual required contribution (ARC) equaled zero and the interest on the NPO closely approximated the adjustment to the ARC. The APC, the percentage of APC contributed, and the NPO for the last three years are shown in Table 28. An actuarial valuation of the LRF's assets and liabilities is made annually. Information on the last valuation, which was performed as of June 30, 2003, is also shown in Table 28. The aggregate cost method that was used for the June 30, 2003, valuation does not identify or separately amortize the unfunded actuarial accrued liability; therefore, this liability is not shown in Table 28.

E. Volunteer Firefighters' Length of Service Award Fund

Plan Description: CalPERS administers the VFF, which is an agent multiple-employer defined benefit retirement plan. The VFF membership includes volunteer firefighters. There were 61 fire departments participating in the VFF for the year ended June 30, 2004.

The actuarial accrued liability of the VFF exceeded the actuarial value of assets by $420,000 at June 30, 2003. This is a result of the difference between the actuarial accrued liability of $3.2 million and the actuarial value of assets of $2.8 million. Contributions are actuarially determined.

F. State Peace Officers' and Firefighters' Defined Contribution Plan Fund

Plan Description: CalPERS administers the SPOFF, which is a defined contribution pension plan. The plan is a qualified money purchase pension plan under Section 401(a) of Title 26 of the Internal Revenue Code, and it is intended to supplement the retirement benefits provided by the Public Employees' Retirement Fund to eligible correctional employees employed by the State of California.

Funding Policy: Contributions to the plan are funded entirely by the primary government with a contribution rate of 2% of the employee's base pay, not to exceed contribution limits established by the Internal Revenue Code. Contribution requirements are established and may be amended through a memorandum of understanding from the State of California Department of Personnel Administration. These contributions, as well as the participant's share of the net earnings of the fund, are credited to the participant's account. For the year ended June 30, 2004, contributions by the primary government to the SPOFF were approximately $41 million.

The net earnings of the fund are allocated to the participant's account as of each valuation date, in the ratio that the participant's account balance bears to the aggregate of all participants' account balances. The benefit paid to a participant will depend only on the amount contributed to the participant's account and earnings on the value of the participant's account. Plan provisions are established by and may be amended by statute. At June 30, 2004, there were 34,903 participants.

G. Teachers' Retirement Fund

Plan Description: CalSTRS administers the Teachers' Retirement Fund, which is an employee benefit trust fund created to administer the State Teachers' Retirement Plan (STRP). The STRP is a defined benefit pension plan that provides for retirement, disability, and survivor benefits. The STRP is comprised of three programs: the Defined Benefit (DB) Program, the Defined Benefit Supplement (DBS) Program, and the Cash Balance (CB) Benefit Program. The STRP is a cost-sharing, multiple-employer, defined benefit retirement plan that provides pension benefits to teachers and certain other employees of the California public school system.

Membership in the DB Program is mandatory for all employees meeting the eligibility requirements. The DB Program provides benefits based on a member's age, final compensation, and years of service. Vesting occurs after five years. In addition, the retirement program provides benefits to members upon disability and to survivors upon the death of eligible members. The Teachers' Retirement Law establishes the benefits for the DB Program. At June 30, 2004, the DB Program had approximately 1,200 contributing employers, approximately 553,000 active and inactive program members, and 182,000 benefit recipients. The primary government is a nonemployer contributor to the DB Program. The payroll for employees covered by the DB Program for the year ended June 30, 2004, was approximately $23.3 billion.

Membership in the DBS Program is automatic for all members of the DB Program. The DBS Program provides benefits based on the balance of member accounts. Vesting occurs immediately. The Teachers' Retirement Law establishes the benefits for the DBS Program. The primary government does not contribute to the DBS Program.

The CB Program is designed for employees of California public schools who are hired to perform creditable service for less than 50% of the full-time equivalent for the position. Participation in the CB Program is optional to employers. However, if the employer elects to offer the CB Program, each eligible employee will automatically be covered by the CB Program unless the member elects to participate in the DB Program or an alternative plan provided by the employer within 60 days of hire. At June 30, 2004, the CB Program had 28 contributing school districts and approximately 18,000 contributing participants.

Funding Policy: DB Program benefits are funded by contributions from members, employers, the primary government, and earnings from investments. Member and employer contributions are a percentage of applicable member earnings. The Teachers' Retirement Law governs member rates, employer contribution rates, and primary government contributions.

The DB Program contribution rate of members is 6% of creditable compensation through December 31, 2010, increasing to 8% thereafter for service less than or equal to one year of creditable service per fiscal year. The employer contribution rate is 8.25% of creditable compensation for service less than or equal to one year of creditable service per fiscal year; for service in excess of one year within one fiscal year, the employer contribution rate is 0.25%. In fiscal year 2003-04, the General Fund contribution was 2.017% of total creditable compensation of the fiscal year ending in the prior calendar year (i.e., the creditable compensation in 2001-02 for the 2003-04 fiscal year). Up to an additional 1.505% of creditable earnings from the immediately preceding calendar year is transferred to the DB Program to amortize the unfunded actuarial obligation and to eliminate any normal cost deficit attributable to benefits in effect as of July 1, 1990. The normal cost deficit is the difference between the normal cost rate and the member and employer contributions, which equal 16.25% of creditable compensation. Based on the most recent actuarial valuation, as of June 30, 2003, there is no normal cost deficit but there is an unfunded obligation for benefits in place as of July 1, 1990. Therefore, the General Fund is required to contribute quarterly payments starting October 1, 2004, at a contribution rate of 0.524%.

The DBS Program member contribution rate is 2% of creditable compensation for service less than or equal to one year of creditable service per fiscal year. For service in excess of one year within one fiscal year, the member contribution rate is 8% and the employer rate is 8%.

For the year ended June 30, 2004, the annual pension cost (APC) for the DB Program was approximately $3.5 billion, and the employer and primary government contributions were approximately $1.9 billion and $0.5 billion, respectively. The APC and the percentage of APC contributed for the last three years are shown in Table 28. Actuarial valuations of the DB Program are performed biennially. Information from the last valuation is shown in Table 28.

H. CalSTRS Voluntary Investment Program

Plan Description: CalSTRS administers the Voluntary Investment Program (VIP), a 403(b) program, through a third-party administrator. The VIP is a defined contribution plan and is open to any employee who is eligible to participate. Contributions to the program are voluntary; however, the Internal Revenue Code does impose a maximum amount that can be contributed annually. At June 30, 2004, the VIP had 448 participating employers (school districts) and 3,388 plan members.

I. Teachers' Health Benefits Fund

Plan Description: CalSTRS administers the Teachers' Health Benefits Fund (THBF), which was established pursuant to Chapter 1032, Statutes of 2000 (SB 1435), to provide the Medicare Premium Payment Program for eligible retired members of the DB Program. At June 30, 2004, there were 5,884 benefit recipients.

Funding Policy: The THBF is funded as needed by that portion of the monthly DB Program statutory employer contribution that exceeds the DB Program annual required contribution.

J. University of California Retirement System

The University of California Retirement System (UCRS) consists of: the University of California Retirement Plan (UCRP), a single-employer defined benefit plan funded with university and employee contributions; the Public Employees' Retirement System Voluntary Early Retirement Incentive Program (PERS-VERIP), a defined benefit plan for university employees who elected early retirement under the plan; and two defined contribution plans with several investment portfolios funded with employee non-elective and elective contributions. Most university career employees participate in the UCRS.

The UCRS uses the accrual basis of accounting. As of June 30, 2004, employee and employer contributions were not required to UCRP and PERS-VERIP, due to the fully funded status of each plan. Any contributions made in connection with service credit buybacks are recognized in the period in which they are made. Benefits and refunds are recognized when due and payable, in accordance with the terms of each plan.

The UCRP provides lifetime retirement income, disability protection, death benefits, and pre-retirement survivor benefits to eligible employees of the University of California and its affiliates. Membership in the retirement plan is required for all employees appointed to work at least 50% time for a year or more. Generally, an employee must have five years of service to be entitled to plan benefits. The maximum monthly benefit is

100% of the employee's highest average compensation over a 36-month period. The amount of the pension benefit is determined by salary rate, age, and years of service credit, with certain cost-of-living adjustments.

Members' contributions to the UCRP are accounted for separately and accrue interest at 6% annually. Upon termination, members can elect a refund of their contributions plus accumulated interest. Vested terminated members who are eligible to retire can also elect a lump-sum payment equal to the present value of their accrued benefits. Either action results in the member's forfeiture of rights to further accrued benefits.

At June 30, 2004, plan membership totaled 184,783, comprised of 123,717 active members, 21,328 inactive members (terminated vested employees entitled to benefits but not yet receiving them), and 39,738 retirees and beneficiaries currently receiving benefits. The active members include 70,480 current employees who are fully vested and 53,237 nonvested current employees covered by the plan. A total of 18,546 terminated nonvested employees are not members of the plan but are eligible for a refund.

The funding policy of the Regents of the University of California (regents) provides for actuarially determined contributions at rates that provide for sufficient assets to be available when benefits are due. The contribution rate is determined using the entry age normal actuarial funding method. The significant actuarial assumptions used to compute the actuarially determined contribution are the same as those used to compute the actuarial accrued liability.

The annually determined rates for employer contributions as a percentage of payroll are based on recommendations of the consulting actuary and on appropriations received from the primary government.

Employees may be required to contribute to the UCRP. The rate of employee contributions is established annually as a percentage of covered wages, pursuant to the regents' funding policy, recommended and certified by an enrolled, independent actuary and approved by the regents, the plan's trustee. During the year ended June 30, 2004, employee contributions to the UCRP were redirected to the University of California Defined Contribution Plan.

For the year ended June 30, 2004, there were no employer contributions, annual pension costs, or net pension obligations. The annual pension cost was equal to the actuarially determined contribution.

The actuarial value of assets was determined using techniques that smooth the effect of short-term volatility in the fair value of investments over a five-year period. The actuarial value of assets in excess of the actuarial accrued liability is being amortized as a level percentage of projected payroll on an open basis. The remaining amortization period at June 30, 2004, was six years.

In November 2002, the regents approved a capital accumulation provision accrual credit, effective April 1, 2003. Each active member received a credit equal to 5% of eligible covered compensation earned between April 1, 2002, and March 31, 2003, plus annual interest at the assumed earnings rate of the UCRP. This plan amendment increased the actuarial accrued liability by approximately $322 million for the year ended June 30, 2003.

The PERS-VERIP is a defined benefit pension plan providing lifetime supplemental retirement income and survivor benefits to members of the University of California CalPERS program (UC-PERS) who elected early retirement under provisions of the plan. The university contributed to the CalPERS program on behalf of these UC-PERS members. At June 30, 2004, there were 798 retirees or beneficiaries receiving benefits under this voluntary early retirement program. The cost of contributions made to the plan is borne entirely by the university and the U.S. Department of Energy laboratories. Over the five-year period ended June 30, 1996, the university and the U.S. Department of Energy laboratories were required to make contributions to the plan sufficient to maintain the promised benefits and the qualified status of the plan, as determined by the plan's consulting actuary.

The University of California maintains two defined contribution plans that provide savings incentives and additional retirement security for all eligible university employees. The Defined Contribution Plan (DC Plan) accepts both after-tax and pre-tax contributions. Effective July 1, 2001, the regents adopted a provision for matching employer and employee contributions to the DC Plan related to certain summer session teaching or research compensation for eligible academic employees. Employer contributions to the DC Plan were \$3.8 million for the year ended June 30, 2004. In addition, the university has established a Tax-Deferred 403(b) Plan (403(b) Plan). There are no employer contributions to the 403(b) Plan. Participants in the DC Plan and the 403(b) Plan may direct their elective and nonelective contributions to investment funds managed by the treasurer of the regents of the university. Participants may also invest contributions in, and transfer plan accumulations to, certain external mutual funds on a custodial plan basis. The participants' interest in external mutual funds is shown separately on the statement of the plans' fiduciary net assets.

The DC Plan pre-tax contributions are fully vested and are mandatory for all employees who are members of the UCRP. Monthly employee contributions range from approximately 2% to 4% of covered wages, depending on whether wages are above or below the Social Security wage base. The 403(b) Plan and the DC Plan after-tax options are generally available to all university employees.

Additional information on the retirement plans can be obtained from the 2003-04 annual reports of the UCRP, the PERS-VERIP, the DC Plan, and the 403(b) Plan. These reports may be obtained from the University of California, Office of the President – HR/Benefits Dept., Financial Services and Plan Disbursements, 300 Lakeside Drive, Suite 400, Oakland, California 94612.

The annual required contribution for the current year was determined as part of the June 30, 2004, actuarial valuation, which is the latest available information, using the entry age normal actuarial cost method. Significant actuarial assumptions used in the valuation are shown in Table 28. Information from the last valuation is also shown in Table 28.

Table 28

Actuarial Information – Pension Trusts – Primary Government
June 30, 2004

	Public Employees' Retirement Fund	Judges' Retirement Fund	Judges' Retirement II Fund
Last actuarial valuation	June 30, 2003	June 30, 2003	June 30, 2003
Actuarial cost method	Individual Entry Age Normal	Aggregate Cost	Aggregate Entry Age Normal
Amortization method	Level % of Payroll, Closed	None	Level % of Payroll, Closed
Remaining amortization period	13 to 20 years	None	Average of 9 Years
Asset valuation method	Smoothed Market Value	Market Value	Smoothed Market Value
Actuarial assumption			
Investment rate of return	7.75 %	7.00 %	7.25 %
Projected salary increase	3.25 – 19.95	3.25	3.25
Includes inflation at	3.00	3.00	3.00
Post-retirement benefit increases	2 – 5	3.25	3.0
Annual pension costs (in millions)			
Year ended 6/30/02	$ 700	$ 164	$ 11.1
Year ended 6/30/03	1,172	186	15.9
Year ended 6/30/04	2,121	191	18.6
Percent contribution			
Year ended 6/30/02	100 %	40 %	112 %
Year ended 6/30/03	100	53	96
Year ended 6/30/04	100	57	102
Net pension obligation (in millions)			
Year ended 6/30/02	—	$ 899.0	—
Year ended 6/30/03	—	987.1	—
Year ended 6/30/04	—	1,069.4	—
Funding as of last valuation (in millions)			
Actuarial value – assets	$ 62,515	N/A	$ 96
Actuarial accrued liabilities (AAL) – entry age	74,450	N/A	105
Excess of actuarial value of assets over AAL (EAV) (unfunded actuarial accrued liability (UAAL))	(11,935)	N/A	(9)
Covered payroll	12,628	N/A	87
Funded ratio	84 %	N/A	91 %
EAV (UAAL as percent of covered payroll)	95 %	N/A	10 %

* The State is a nonemployer contributor to the State Teachers' Retirement Defined Benefit Program Fund, a cost-sharing multiple-employer plan. The notion of ARC and NPO does not apply to cost-sharing employer plans. However, the local government employers may have a net liability to the plan for their unpaid contractual liability. The State has made its required contributions for the year ending June 30, 2004. The annual pension cost includes the amount related to both the State and the local government employers.

Legislators' Retirement Fund	State Teachers' Retirement Defined Benefit Program Fund *	University of California Retirement Plan Fund	Voluntary Early Retirement Incentive Plan Fund
June 30, 2003	June 30, 2003	June 30, 2004	June 30, 2004
Aggregate Cost	Entry Age Normal	Entry Age Normal	Unit Credit
None	Level % of Payroll, Open	Level % of Payroll, Open	N/A
None	Not amortizable	6 Years	N/A
Smoothed Market Value	Expected Value, With 33% Adjustment to Market Value	Smoothed Fair Value	Fair Value
7.00 %	8.00 %	7.50 %	7.50 %
3.25	4.25	4.5 – 6.5	N/A
3.00	3.25	4.00	4.00
3.00	2.00	N/A	N/A
$ —	$ 2,498	—	—
—	2,545	—	—
—	3,539	—	—
— %	90 %	N/A	N/A
—	91	N/A	N/A
—	67	N/A	N/A
$ 10.2	—	—	—
10.2	—	—	—
10.2	—	—	—
N/A	$ 108,667	$ 41,293	$ 75.7
N/A	131,777	35,034	48.1
N/A	(23,110)	6.259	27.6
N/A	23,862	7.835	—
N/A	82.0 %	117.9 %	157.4 %
N/A	96.8 %	79.9 %	—

NOTE 24: POST-RETIREMENT HEALTH CARE BENEFITS

Health care and dental benefits are provided by the primary government and certain discretely presented component units, to annuitants of retirement systems to which the primary government contributes as an employer. The discretely presented component units' participation in these plans is not a material portion of the program. To be eligible for these benefits, first-tier plan annuitants must retire on or after age 50 with at least five years of service, and second-tier plan annuitants must retire on or after attaining age 55 with at least 10 years of service. In addition, annuitants must retire within 120 days of separation from employment to be eligible to receive these benefits. As of June 30, 2004, approximately 120,900 annuitants were enrolled to receive health benefits and approximately 98,900 annuitants were enrolled to receive dental benefits. In accordance with the California Government Code, the primary government generally pays 100% of the health insurance cost for annuitants, plus 90% of the additional premium required for the enrollment of family members of annuitants. Although the California Government Code does not specify the primary government's contribution toward dental insurance costs, the primary government generally pays all or a portion of the dental insurance cost for annuitants, depending upon the completed years of credited state service at retirement and the dental coverage selected by the annuitant. The primary government recognizes the cost of providing health and dental insurance to annuitants on a pay-as-you-go basis. The cost of these benefits for the year ended June 30, 2004, was approximately $695 million.

Also, the University of California, a discretely presented component unit, provides to retired employees certain health plan benefits in addition to pension benefits. Employees who meet specific requirements may continue their medical and dental benefits into retirement and continue to receive University of California contributions for those benefits. There are approximately 38,200 retirees eligible to receive such benefits. The cost of retiree medical and dental coverage is recognized when paid. The cost of providing medical and dental benefits for retirees and their families and survivors for the year ended June 30, 2004, was $185 milion.

NOTE 25: SUBSEQUENT EVENTS

The following information describes significant events that occurred subsequent to June 30, 2004, but prior to the date of the auditor's report.

The primary government issued $2.3 billion in general obligation bonds to retire previously issued commercial paper, to repay internal state loans, and to finance various school, coastal, and park projects. The primary government also issued revenue anticipation notes of $6.0 billion that are due to be redeemed in June 2005.

The Regents of the University of California issued $372 million in Limited Project Revenue Bonds to finance and refinance the acquisition, construction, renovation, and improvement of certain auxiliary enterprises of the university.

The California State University, Channel Islands Site Authority, issued approximately $99 million in revenue bonds for developing housing and other facilities.

The Department of Water Resources issued $272 million in Central Valley Project Water System revenue bonds to refund outstanding revenue bonds and commercial paper.

The State Public Works Board, an agency that accounts for its activities as an enterprise fund, issued lease revenue bonds totaling $166 million for the benefit of the Regents of the University of California and the Department of Forestry and Fire Protection, to finance and refinance the cost of certain capital improvements.

The California Infrastructure and Economic Development Bank issued Workers' Compensation Relief Revenue Bonds totaling $750 million.

In August 2004, Standard and Poor's raised its rating on California's general obligation bonds from "BBB" to "A," and on General Fund lease-supported debt from "BBB-" to "A-."

In September 2004, Fitch Ratings raised its rating on California's general obligation bonds from "BBB" to "A-."

The California Stem Cell Research and Cures Initiative (Proposition 71), approved by California voters on November 2, 2004, authorizes the sale of up to $3.0 billion in general obligation bonds to fund grants and facilities for stem cell research.

The Children's Hospital Projects Initiative (Proposition 61), approved by California voters on November 2, 2004, authorizes the sale of up to $750 million in general obligation bonds for capital improvement projects at children's hospitals.

Required Supplementary Information

Schedule of Funding Progress [1]

Public Employees' Retirement Fund

(amounts in millions)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Excess of Actuarial Value of Assets Over AAL (Unfunded Actuarial Accrued Liability (UAAL)) (a - b)	Funded Ratio (a / b)	Covered Payroll (c)	Excess (UAAL) as a Percentage of Covered Payroll ((a - b) / c)
June 30, 2001	$ 66,976	$ 64,567	$ 2,409	103.7 %	$ 11,905	20.2 %
June 30, 2002	62,201	68,854	(6,653)	90.3	12,425	(53.5)
June 30, 2003	62,515	74,450	(11,935)	84.0	12,628	(94.5)

Judges' Retirement Fund II

(amounts in thousands)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Excess of Actuarial Value of Assets Over AAL (Unfunded Actuarial Accrued Liability (UAAL)) (a - b)	Funded Ratio (a / b)	Covered Payroll (c)	Excess (UAAL) as a Percentage of Covered Payroll ((a - b) / c)
June 30, 2001	$ 55,955	$ 60,933	$ (4,979)	91.8 %	$ 61,547	(8.1) %
June 30, 2002	71,929	76,459	(4,530)	94.1	72,804	(6.2)
June 30, 2003	96,107	105,116	(9,009)	91.4	87,295	(10.3)

State Teachers' Retirement Defined Benefit Program[2]

(amounts in millions)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Excess of Actuarial Value of Assets Over AAL (Unfunded Actuarial Accrued Liability (UAAL)) (a - b)	Funded Ratio (a / b)	Covered Payroll (c)	Excess (UAAL) as a Percentage of Covered Payroll ((a - b) / c)
June 30, 2000	$ 102,225	$ 93,124	$ 9,101	109.8 %	$ 18,224	49.9 %
June 30, 2001	107,654	109,881	(2,227)	98.0	20,585	(10.8)
June 30, 2003	108,667	131,777	(23,110)	82.5	23,862	(96.8)

[1]Actuarial valuations for the Judges' Retirement Fund and the Legislators' Retirement Fund are performed using the aggregate actuarial cost valuation method. The schedule of funding progress is not required if this method is used.

[2]Beginning July 1, 2001, actuarial valuations are not prepared in even-numbered years. No estimation using actuarial methodology is made in years between valuations.

University of California Retirement System
(amounts in millions)

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Excess of Actuarial Value of Assets Over AAL (a - b)	Funded Ratio (a / b)	Covered Payroll (c)	Excess as a Percentage of Covered Payroll ((a - b) / c)
June 30, 2002	$ 41,649	$ 30,100	$ 11,549	138.4 %	$ 7,227	159.8 %
June 30, 2003	41,429	32,955	8,474	125.7	7,734	109.6
June 30, 2004	41,293	35,034	6,259	117.9	7,835	79.9

Infrastructure Assets Using the Modified Approach

As allowed by Governmental Accounting Standards Board (GASB) Statement No. 34, the State has adopted the Modified Approach, an alternative method to depreciating the cost of its infrastructure (state roadways and bridges). Under the Modified Approach, the State does not report depreciation expense for roads and bridges but capitalizes costs that add to the capacity and/or efficiency of state-owned roads and bridges. All maintenance and preservation costs are expensed, not capitalized.

The modified approach requires the State to:

- Maintain an asset management system that includes current inventory of eligible infrastructure assets.
- Perform condition assessments of eligible assets and summarize the results in a measurable scale.
- Document that the eligible infrastructure assets are being preserved at or above the condition level established and disclosed by the State.
- Estimate each year the annual amount needed to maintain and preserve the eligible infrastructure assets at the condition level established and disclosed by the State.

Infrastructure Asset Reporting Categories: The infrastructure assets reported in the financial statements for the fiscal year ending June 30, 2004, are in the following categories: state highway infrastructure (completed highway projects); land (land purchased for highway projects); and construction in progress (uncompleted highway projects).

Donation: Donation and relinquishment activity affects the inventory of statewide lane miles, land, and/or bridges, as adjustments to infrastructure assets and/or land balances in the financial statements. The State will report donation and relinquishment activity no later than the fiscal year ending June 30, 2006, as required by GASB Statement No. 34.

Budgeted and Actual Preservation Costs: The State is providing budgeted and actual preservation costs only for the fiscal year ending June 30, 2004, because this is the first year the State is reporting this information. In succeeding years, the State will report cumulative budgeted and actual preservation cost information until five fiscal years are reported, as required by GASB Statement No. 34. Estimated and actual preservation costs are as follows:

Estimated budgeted preservation costs	$975 million
Actual preservation costs	$717 million

Condition Baselines and Assessments: The State is providing condition assessments only for the fiscal year ending June 30, 2004, because this is the first year the State is reporting this information. In succeeding years, the State will report cumulative condition assessments until the most recent and two previous condition assessments are reported, as required by GASB Statement No. 34.

Bridges: The State is using the Bridge Health Index—a numerical rating scale from 0% to 100% that utilizes element-level inspection data—to determine the aggregate condition of its bridges. The inspection data is based on the American Association of State Highway and Transportation Officials (AASHTO) "Commonly Recognized Structural Elements" standard.

From a deterioration standpoint, the Bridge Health Index represents the remaining asset value of a bridge. A new bridge has 100% of its asset value and an equivalent Bridge Health Index of 100%. As a bridge deteriorates over time, it loses asset value, as represented by a decline in its Bridge Health Index. When a deteriorated bridge is repaired, it regains some (or all) of its asset value and its Bridge Health Index increases, possibly to 100%. The State's established condition baseline and the actual Bridge Health Index are as follows:

Established condition baseline, Bridge Health Index [1]	80.0%
Actual Bridge Health Index	94.2%

Roadways: The State is using AASHTO's "Pavement Performance Data Collection Protocols" in its annual pavement condition survey, which evaluates ride quality and structural integrity and is used to identify distressed lane miles. The actual distressed lane miles are compared to the established condition baseline to ensure it is not exceeded. The state-established condition baseline and the actual distressed lane miles are as follows:

Established condition baseline, distressed lane miles (maximum)[2]	18,000
Actual distressed lane miles	11,824

[1]The actual statewide Bridge Health Index (BHI) should not be lower than the minimum BHI established by the State.

[2]The actual statewide distressed lane miles should not exceed the maximum distressed lane miles established by the State.

Budgetary Comparison Schedule
General Fund and Major Special Revenue Funds

Year Ended June 30, 2004
(amounts in thousands)

	General			
	Budgeted Amounts		Actual	Variance With
	Original	Final	Amounts	Final Budget
REVENUES				
Corporation tax	$ —	$ —	$ 7,019,216	$ —
Intergovernmental	—	—	—	—
Cigarette and tobacco taxes	—	—	117,137	—
Inheritance, estate, and gift taxes	—	—	397,848	—
Insurance gross premiums tax	—	—	2,114,979	—
Vehicle license fees	—	—	18,678	—
Motor vehicle fuel tax	—	—	—	—
Personal income tax	—	—	36,398,982	—
Retail sales and use taxes	—	—	23,847,329	—
Other major taxes and licenses	—	—	315,256	—
Other revenues	—	—	3,920,421	—
Total revenues	**—**	**—**	**74,149,846**	**—**
EXPENDITURES				
State and consumer services	447,877	471,690	458,806	12,884
Business and transportation	314,399	315,050	309,325	5,725
Resources	715,705	864,855	790,088	74,767
Health and human services	24,125,478	23,185,893	22,784,077	401,816
Correctional programs	5,526,345	5,298,251	5,244,140	54,111
Education	36,980,680	37,159,261	37,075,975	83,286
General government:				
Tax relief	4,037,212	4,048,525	4,043,092	5,433
Debt service	2,127,095	2,131,337	2,103,542	27,795
Other general government	5,519,849	5,722,671	5,648,678	73,993
Total expenditures	**79,794,640**	**79,197,533**	**78,457,723**	**739,810**
OTHER FINANCING SOURCES (USES)				
Transfers from other funds	—	—	12,168,789	—
Transfers to other funds	—	—	(279,013)	—
Other additions and deductions	—	—	124,946	—
Total other financing sources (uses)	**—**	**—**	**12,014,722**	**—**
Excess of revenues and other sources over expenditures and other uses	—	—	7,706,845	—
Fund balances (deficits), July 1, 2003	**—**	**—**	**(4,397,361) ***	**—**
Fund balances (deficits), June 30, 2004	**$ —**	**$ —**	**$ 3,309,484**	**$ —**

* Restated

Federal				Transportation Construction			
Budgeted Amounts		Actual	Variance With	Budgeted Amounts		Actual	Variance With
Original	Final	Amounts	Final Budget	Original	Final	Amounts	Final Budget
$ —	$ —	$ —	$ —	$ —	$ —	$ —	$ —
—	—	36,408,371	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	797,430	—
—	—	—	—	—	—	3,324,883	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—
—	—	343	—	—	—	216,020	—
—	**—**	**36,408,714**	**—**	**—**	**—**	**4,338,333**	**—**
9,195	9,195	9,195	—	1	1	—	1
2,402,198	2,402,198	2,402,198	—	3,820,380	3,802,239	3,583,753	218,486
236,721	236,721	236,721	—	12	12	12	—
23,937,188	23,937,188	23,937,188	—	—	—	—	—
1,004,659	1,004,659	1,004,659	—	—	—	—	—
6,493,494	6,493,494	6,493,494	—	980	980	980	—
—	—	—	—	—	—	—	—
—	—	—	—	500	500	214	286
1,183,489	1,183,489	1,183,489	—	1,242,615	1,246,248	1,240,776	5,472
35,266,944	**35,266,944**	**35,266,944**	**—**	**5,064,488**	**5,049,980**	**4,825,735**	**224,245**
—	—	7,333,942	—	—	—	6,288,075	—
—	—	(8,477,296)	—	—	—	(6,386,094)	—
—	—	—	—	—	—	1,829,664	—
—	**—**	**(1,143,354)**	**—**	**—**	**—**	**1,731,645**	**—**
—	—	(1,584)	—	—	—	1,244,243	—
—	**—**	**13,266** *	**—**	**—**	**—**	**1,813,560** *	**—**
$ —	**$ —**	**$ 11,682**	**$ —**	**$ —**	**$ —**	**$ 3,057,803**	**$ —**

Reconciliation of Budgetary Basis Fund Balances of the General Fund and the Major Special Revenue Funds to GAAP Basis Fund Balances

June 30, 2004
(amounts in thousands)

		Special Revenue Funds	
	General	Federal	Transportation Construction
Perspective difference:			
Budgetary / Legal Basis Annual Report	$ 3,309,484	$ 11,682	$ 3,057,803
Nongovernmental cost funds	2,012,000	—	—
Budgetary fund balance reclassified into GAAP statement fund structure	**5,321,484**	**11,682**	**3,057,803**
Basis difference:			
Interfund receivables	41,628	—	648,900
Loans receivable	105,813	43,986	—
Interfund payables	(2,417,377)	—	—
Escheat property	(880,226)	—	—
Other	5,129	—	3,535
Timing difference:			
Liabilities budgeted in subsequent years	(3,717,151)	(9)	(66,046)
GAAP fund balance, June 30, 2004	**$ (1,540,700)**	**$ 55,659**	**$ 3,644,192**

Notes to the Required Supplementary Information

Budgetary Comparison Schedule

The State annually reports its financial condition based on GAAP (GAAP basis) and on the State's budgetary provisions (budgetary basis). The Budgetary Comparison Schedule, General Fund and Major Special Revenue Funds, reports the original budget, the final budget, the actual expenditures, and the variance between the final budget and the actual expenditures, using the budgetary basis of accounting.

On a budgetary basis, individual appropriations are charged as expenditures when commitments for goods and services are incurred. However, for financial reporting purposes, the State reports expenditures based on the year goods and services are received. The Budgetary Comparison Schedule includes all of the current-year expenditures for the General Fund and major special revenue funds and their related appropriations that are legislatively authorized annually, continually, or by project. On a budgetary basis, adjustments for encumbrances are budgeted under other general government, while the encumbrances relate to all programs' expenditures.

The Budgetary Comparison Schedule is not presented in this document at the legal level of budgetary control because such a presentation would be extremely lengthy and cumbersome. The State of California prepares a separate report, the *Budgetary/Legal Basis Annual Report Supplement*, which includes statements that demonstrate compliance with the legal level of budgetary control in accordance with GASB's *Codification of Governmental Accounting and Financial Reporting Standards*, Section 2400.121. The Statement of Appropriations, Expenditures, and Balances and the Comparative Statement of Actual and Budgeted

Expenditures include the comparison of the annual appropriated budget with expenditures at the legal level of control. The Federal Fund, which is a major special revenue fund, and a minor program of the Highway Construction Fund are not included in the *Annual Report Supplement* statements, because they are considered fiduciary fund activities on the budgetary basis. A copy of this report is available from the State Controller's Office, Division of Accounting and Reporting, P.O. Box 942850, Sacramento, California 94250.

Reconciliaton of Budgetary Basis With GAAP Basis

The Reconciliation of Budgetary Basis Fund Balances of the General Fund and the major special revenue funds and GAAP Basis Fund Balances is presented on the previous page and is explained in the following paragraphs.

The beginning fund balances for the General Fund, Federal Fund, and Transportation Construction Fund on the budgetary basis are restated for prior-year revenue adjustments and prior-year expenditure adjustments. A prior-year revenue adjustment occurs when the actual amount received in the current year differs from the amount of revenue accrued in the prior year. A prior-year expenditure adjustment results when the actual amount paid in the current year differs from the prior-year accrual for appropriations whose ability to encumber funds has lapsed in previous periods. The beginning fund balance on a GAAP basis is not affected by these adjustments.

Perspective Difference

Fund Classification: On a budgetary basis, the State's funds are classified as either governmental cost funds or nongovernmental cost funds. The governmental cost funds consist of the General Fund and other funds into which revenues from taxes, licenses, and fees that support the general operations of the State are deposited. The nongovernmental cost funds are not subject to annual appropriated budgets and consist of funds into which monies derived from sources other than general and special taxes, licenses, fees, or other state revenues are deposited. The Deficit Recovery Fund is classified as a nongovernmental cost fund on a budgetary basis and represents unused proceeds from bonds issued pursuant to the Economic Recovery Bond Act that are used to reimburse General Fund expenditures. Accordingly, on a GAAP basis the Deficit Recovery Fund is included in the General Fund.

Basis Difference

Interfund Receivables and Loans Receivable: Loans made to other funds or to other governments are normally recorded as expenditures on the budgetary basis. However, in accordance with GAAP, these loans are recorded as assets. The adjustments related to interfund receivables caused a $42 million increase to the fund equity in the General Fund and a $649 million increase to the fund equity in the Transportation Construction Fund. The adjustments related to loans receivable caused increases of $106 million in the General Fund and $44 million in the Federal Fund.

Interfund Payables: Loans received from other funds are normally recorded as revenues on a budgetary basis. However, in accordance with GAAP, these loans are recorded as liabilities. The adjustments related to interfund payables caused a $2.4 billion decrease to the budgetary fund balance in the General Fund.

Escheat Property: A liability for the estimated amount of escheat property ultimately expected to be reclaimed and paid is not reported on a budgetary basis, while it is required to be reported in the interfund payables on a GAAP basis. This adjustment caused a $880 million decrease to the General Fund balance.

Other: Certain other adjustments and reclassifications are necessary to present the financial statements in accordance with GAAP. The other adjustments caused fund balance increases of $5 million in the General Fund and $4 million in the Transportation Construction Fund.

Timing Difference

Liabilities Budgeted in Subsequent Years: On a budgetary basis, the primary government does not accrue liabilities for which there is no existing appropriation or no currently available appropriation. The adjustments made to account for these liabilities in accordance with GAAP caused fund balance decreases of $3.7 billion in the General Fund, $9,000 in the Federal Fund, and $66 million in the Transportation Construction Fund. The large decrease in the General Fund primarily consists of $1.6 billion for deferred apportionment payments to K-12 schools and community colleges and $1.1 billion for medical assistance.

Part Two

State of California: Internal Control and State and Federal Compliance Audit Report for the Year Ended June 30, 2004

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AUDITOR'S SECTION

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Independant Auditor’s Reports on Internal Control and on Compliance and Other Matters

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ELAINE M. HOWLE
STATE AUDITOR

STEVEN M. HENDRICKSON
CHIEF DEPUTY STATE AUDITOR

Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance With Government Auditing Standards

The Governor and the Legislature of
the State of California

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of California, as of and for the year ended June 30, 2004, which collectively comprise the State of California's basic financial statements, and have issued our report thereon dated January 28, 2005. We did not audit the following significant amounts in the financial statements of:

Government-wide Financial Statements

- Certain enterprise funds that, in the aggregate, represent 85 percent, 41 percent, and 50 percent, respectively, of the assets, net assets and revenues of the business-type activities.

- The University of California, State Compensation Insurance Fund, California Housing Finance Agency, and certain other funds that, in the aggregate, represent 76 percent, 89 percent, and 75 percent, respectively, of the assets, net assets and revenues of the discretely presented component units.

Fund Financial Statements

- The following major enterprise funds: Electric Power fund, Water Resources fund, Public Building Construction fund, and State Lottery fund.

- Certain nonmajor enterprise funds that represent 70 percent, 45 percent, and 81 percent, respectively, of the assets, net assets and revenues of the nonmajor enterprise funds.

- The funds of the Public Employees' Retirement System, State Teachers' Retirement System and the University of California Retirement System that, in the aggregate, represent 91 percent, 92 percent, and 70 percent, respectively, of the assets, net assets and additions of the fiduciary funds and similar component units.

- The discretely presented component units noted above.

Those financial statements were audited by other auditors whose reports have been furnished to us, and our opinions, insofar as it relates to the amounts included for those funds and entities, are based on the reports of the other auditors. Except as discussed in the following paragraph, we conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States of America.

The financial statements of the State Compensation Insurance Fund (SCIF) have not been audited and we were not engaged to audit the SCIF financial statements as part of our audit of the State of California's basic financial statements. SCIF's financial activities are included in the State of California's basic financial statements as a discretely presented component unit and represent 24 percent, 9 percent, and 24 percent of the assets, net assets, and revenues, respectively, of the State of California's aggregate discretely presented component units.

In addition, management has not included the California Earthquake Authority (CEA) in the State of California's financial statements. Accounting principles generally accepted in the United States of America require the CEA to be presented as a discretely presented component unit and financial information about the CEA to be part of the aggregate discretely presented component units, thus increasing the component units' assets, liabilities, revenues, and expenses, and changing its net assets. The amount by which this departure would affect the assets, liabilities, net assets, revenues, and expenses of the State of California's aggregate discretely presented component units is not reasonably determinable.

INTERNAL CONTROL OVER FINANCIAL REPORTING

In planning and performing our audit, we considered the State of California's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinions on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the State of California's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items 2004-19-1 through 2004-19-4.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe none of the reportable conditions described above is a material weakness.

COMPLIANCE AND OTHER MATTERS

As part of obtaining reasonable assurance about whether the State of California's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the governor and Legislature of the State of California, the management of the executive branch, and the federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

BUREAU OF STATE AUDITS

Philip Jelicich

PHILIP J. JELICICH, CPA
Deputy State Auditor

January 28, 2005

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ELAINE M. HOWLE
STATE AUDITOR

STEVEN M. HENDRICKSON
CHIEF DEPUTY STATE AUDITOR

Independent Auditor's Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133

The Governor and the Legislature of
the State of California

COMPLIANCE

We have audited the compliance of the State of California with the types of compliance requirements described in the *U. S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 2004. The State of California's major federal programs are identified in the summary of the auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of the State of California's management. Our responsibility is to express an opinion on the State of California's compliance based on our audit.

The State of California's basic financial statements include the operations of the University of California and the California State University systems, as well as the California Housing Finance Agency, a component unit authority of the State. However, these entities are not included in the accompanying schedule of findings and questioned costs or schedule of federal assistance for the year ended June 30, 2004. The University of California and the California State University systems, and the California Housing Finance Agency, which reported expenditures of federal awards totaling $3.0 billion, $1.3 billion, and $73.1 million, respectively, engaged other auditors to perform an audit in accordance with OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133).

Except as discussed in the following paragraph, we conducted our audit of compliance in accordance with auditing standards generally accepted in the United States of America; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and OMB Circular A-133. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about the State of California's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit and the reports of the other auditors provide a reasonable basis for our opinion. Our audit does not provide a legal determination of the State of California's compliance with those requirements.

As described in item 2004-1-4 in the accompanying schedule of findings and questioned costs, because of inadequacies in the accounting records, we were unable to obtain sufficient documentation supporting the State's compliance with the Crime Victim Assistance program's (CFDA 16.575) requirements relating to activities allowed, allowable costs, cash management, eligibility, period of availability, and reporting, nor were we able to satisfy ourselves as to compliance with those requirements by other auditing procedures.

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding the State of California's compliance with the Crime Victim Assistance program's requirements relating to activities allowed, allowable costs, cash management, eligibility, period of availability, and reporting, the State of California complied in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 2004. The results of our auditing procedures also disclosed other instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs. See the attachment for a list of these issues.

INTERNAL CONTROL OVER COMPLIANCE

The management of the State of California is responsible for establishing and maintaining effective internal control over compliance with requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered the State of California's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect the State of California's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs. The attachment also contains a list of these issues.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants caused by error or fraud that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider item 2004-1-4 to be a material weakness.

SCHEDULE OF FEDERAL ASSISTANCE

We have audited the financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of California, as of and for the year ended June 30, 2004, which collectively comprise the State of California's basic financial statements, and have issued our report thereon dated January 28, 2005. We did not audit the following significant amounts in the financial statements of:

Government-wide Financial Statements

- Certain enterprise funds that, in the aggregate, represent 85 percent, 41 percent, and 50 percent, respectively, of the assets, net assets and revenues of the business-type activities.

- The University of California, State Compensation Insurance Fund, California Housing Finance Agency, and certain other funds that, in the aggregate, represent 76 percent, 89 percent, and 75 percent, respectively, of the assets, net assets and revenues of the discretely presented component units.

Fund Financial Statements

- The following major enterprise funds: Electric Power fund, Water Resources fund, Public Building Construction fund, and State Lottery fund.

- Certain nonmajor enterprise funds that represent 70 percent, 45 percent, and 81 percent, respectively, of the assets, net assets and revenues of the nonmajor enterprise funds.

- The funds of the Public Employees' Retirement System, State Teachers' Retirement System and the University of California Retirement System that, in the aggregate, represent 91 percent, 92 percent, and 70 percent, respectively, of the assets, net assets and additions of the fiduciary funds and similar component units.

- The discretely presented component units noted above.

Those financial statements were audited by other auditors whose reports have been furnished to us, and our opinions, insofar as it relates to the amounts included for those funds and entities, are based on the reports of the other auditors.

In addition, the financial statements of the State Compensation Insurance Fund (SCIF) have not been audited and we were not engaged to audit the SCIF financial statements as part of our audit of the State of California's basic financial statements. SCIF's financial activities are included in the State of California's basic financial statements as a discretely presented component unit and represent 24 percent, 9 percent, and 24 percent of the assets, net assets, and revenues, respectively, of the State of California's aggregate discretely presented component units.

Further, management has not included the California Earthquake Authority (CEA) in the State of California's financial statements. Accounting principles generally accepted in the United States of America require the CEA to be presented as a discretely presented component unit and financial information about the CEA to be part of the aggregate discretely presented component units, thus increasing component units' assets, liabilities, revenues, and expenses, and changing its net assets. The amount by which this departure would affect the assets, liabilities, net assets, revenues, and expenses of the State of California's aggregate discretely presented component units is not reasonably determinable.

Our audit was performed for the purpose of forming opinions on the financial statements that collectively comprise the State of California's basic financial statements. The accompanying schedule of federal assistance is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the basic financial statements. OMB Circular A-133 requires the schedule of federal assistance to present total expenditures for each federal assistance program. However, although the State's automated accounting system separately identifies receipts for each federal assistance program, it does not separately identify expenditures for each program. As a result, the State presents the schedule of federal assistance on a cash receipts basis. In addition, the schedule of federal assistance does not include expenditures of federal awards received by the University of California and the California State University systems, or the California Housing Finance Agency. These expenditures are audited by other independent auditors in accordance with OMB Circular A-133. The information in the accompanying schedule has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole.

This report is intended solely for the information and use of the governor and Legislature of the State of California, the management of the executive branch, and the federal awarding agencies and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

BUREAU OF STATE AUDITS

Philip Jelicich

PHILIP J. JELICICH, CPA
Deputy State Auditor

January 28, 2005

Attachment

ATTACHMENT

The compliance issues are:

2004-1-1
2004-1-2
2004-1-3
2004-1-4
2004-1-5
2004-1-6
2004-2-1
2004-3-1
2004-3-3
2004-3-4
2004-3-5
2004-3-8
2004-3-9
2004-3-10
2004-3-12
2004-5-1
2004-5-3
2004-7-1
2004-12-1
2004-12-2
2004-12-3
2004-12-4
2004-12-5
2004-13-1
2004-13-2
2004-13-3
2004-13-5
2004-13-6
2004-13-7
2004-13-8
2004-13-9
2004-13-10
2004-13-11
2004-13-12
2004-13-13
2004-13-14
2004-13-15
2004-14-1
2004-14-2
2004-14-4
2004-14-5

The internal control over compliance issues are:

2004-1-2
2004-1-3
2004-1-4
2004-2-1
2004-3-1
2004-3-2
2004-3-3
2004-3-4
2004-3-5
2004-3-6
2004-3-7
2004-3-8
2004-3-9
2004-3-11
2004-3-12
2004-5-2
2004-5-3
2004-7-1
2004-7-2
2004-7-3
2004-9-1
2004-9-2
2004-9-3
2004-9-4
2004-9-5
2004-12-2
2004-12-3
2004-12-4
2004-12-5
2001-13-4
2004-13-7
2004-13-9
2004-13-11
2004-13-12
2004-13-13
2004-14-3
2004-14-4

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Schedule of Findings and Questioned Costs

STATE OF CALIFORNIA
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
FOR THE FISCAL YEAR ENDED JUNE 30, 2004

Summary of Auditor's Results

Financial Statements

Type of report issued by auditors	Qualified
Internal control over financial reporting:	
Material weaknesses identified?	No
Reportable conditions identified that are not considered to be material weaknesses?	Yes
Noncompliance material to financial statements noted?	No

Federal Awards

Internal control over major programs:	
Material weaknesses identified?	Yes
Reportable conditions identified that are not considered to be material weaknesses?	Yes
Types of reports the auditor issued on compliance for major programs:	
Crime Victim Assistance (16.575)	Disclaimer
All other major programs	Unqualified
Any audit findings disclosed that are required to be reported in accordance with Section .510(a) of Circular A-133?	Yes
Dollar threshold used to distinguish between Type A and Type B programs*	$72.1 million
Auditee qualified as low-risk auditee?	No

* The accompanying Schedule of Federal Assistance includes 42 programs or clusters of programs with cash receipts exceeding the Type A threshold. However, the expenditures for one of these programs, Other-General Services Administration (39.999), did not meet the Type A threshold and, thus, is not a Type A program.

Identification of major programs:

CFDA Number	Name of Federal Program or Cluster of Programs
	Aging Cluster
	Child Care Cluster
	Emergency Food Assistance Cluster
	Employment Services Cluster
	Food Stamp Cluster
	Highway Planning and Construction Cluster
	Medicaid Cluster
	Special Education Cluster
	Student Financial Aid Cluster
	WIA Cluster
10.557	Special Supplemental Nutrition Program for Women, Infants, and Children
10.558	Child and Adult Care Food Program
14.228	Community Development Block Grant/State's Program
14.239	HOME Investment Partnerships Program
16.007	State Domestic Preparedness Equipment Support Program
16.575	Crime Victim Assistance
16.606	State Criminal Alien Assistance Program
17.225	Unemployment Insurance
21.999	Temporary State Fiscal Relief
39.011	Election Reform Payments
66.468	Capitalization Grants for Drinking Water State Revolving Funds
84.002	Adult Education—State Grant Program
84.010	Title I Grants to Local Educational Agencies
84.011	Migrant Education—State Grant Program
84.048	Vocational Education—Basic Grants to States
84.126	Rehabilitation Services—Vocational Rehabilitation Grants to States
84.298	State Grants for Innovative Programs
84.318	Education Technology State Grants
84.357	Reading First State Grants
84.365	English Language Acquisition Grants
84.367	Improving Teacher Quality State Grants
93.558	Temporary Assistance for Needy Families
93.563	Child Support Enforcement
93.568	Low-Income Home Energy Assistance
93.569	Community Services Block Grant
93.658	Foster Care—Title IV-E
93.767	State Children's Insurance Program
93.917	HIV Care Formula Grants
93.959	Block Grants for Prevention and Treatment of Substance Abuse
97.036 (formerly 83.544)	Public Assistance Grants
97.039 (formerly 83.548)	Hazard Mitigation Grant

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Internal Control Compliance and Issues Applicable to the Financial Statements and State Requirements

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SECRETARY OF STATE

Reference Number 2004-19-1

CONDITION

For the fiscal year ending June 30, 2002, we reported that the Secretary of State's Office did not exercise adequate control over its cash account during fiscal year 2001–2002. At the time of our follow-up review in January 2004, we determined that the Secretary of State's Office continued to lack adequate separation of duties in its accounting unit. Specifically, one employee continued to periodically enter data into the automated cash disbursements register and print signed checks. In its corrective action plan, the Secretary of State's Office stated that it had taken appropriate action to ensure that assets are properly safeguarded.

At the time of our follow-up review in August 2004, we determined that the employee continues to periodically enter data into the automated cash disbursements register and print signed checks. This lack of adequate segregation of duties may allow errors and irregularities to go undetected.

CRITERIA

The California Government Code, Section 13401, requires state agencies to effectively maintain internal accounting and administrative controls. Section 13403 indicates that such controls include segregation of duties appropriate for proper safeguarding of state agency assets. In addition, the State Administrative Manual, Section 8080 and 8080.1, provide that the same person should not maintain books of original entry for cash disbursements and produce signed checks.

RECOMMENDATION

We recommend that the Secretary of State's Office ensure that a single individual is not in a position to enter data into the automated cash disbursements register and print signed checks.

OFFICE'S VIEW AND CORRECTIVE ACTION PLAN

The Secretary of State's Office concurs with our finding and indicates that accounting office will not issue checks unless there is adequate staff to differentiate duties between the process of inputting the data and printing the checks.

DEPARTMENT OF FISH AND GAME

Reference Number: 2004-19-2

CONDITION

For the fiscal year ending June 30, 2003, we reported that the Department of Fish and Game (Fish and Game) had inadequate procedures for accounting and reporting its real property. Fish and Game has two branches that report information on land and buildings and improvements to the Department of General Services' (General Services) Real Estate Services Division for inclusion in the Statewide Property Inventory. Its Land and Facilities Branch is responsible for reporting to General Services and reconciling with the Statewide Property Inventory. Its Fiscal and Administrative Services Branch, Property Unit has the same responsibilities for buildings and improvements. Its accounting unit reports real property information to the State Controller's Office (Controller's Office) for inclusion in the State's financial statements. However, for fiscal year 2001–02, the two branches did not reconcile their data with the Statewide Property Inventory. Further, the two branches and the accounting unit did not reconcile the property listings and Statement of Changes in General Fixed Assets. Also, the accounting unit reported incorrect information to the Controller's Office.

Fish and Game also accounts for and reports real property information for the Wildlife Conservation Board (board). To compare Fish and Game's records to the Statewide Property Inventory, we had to include real property amounts for the board because General Services uses the same agency number for both agencies in the Statewide Property Inventory. Specifically, we determined the following:

- For the year ending June 30, 2002, Fish and Game's property listings for itself and the board had land of approximately $490.1 million and buildings and improvements of approximately $89.0 million, while the Statewide Property Inventory had approximately $587.7 million and $86.9 million, respectively, differences of $97.6 million and $2.1 million, respectively. In some instances, Fish and Game had items on its property listing that we could not match to the Statewide Property Listing. For example, we found 149 land items totaling $56.4 million on the property listing, but not on the Statewide Property Inventory. Also, we found 191 land items totaling $150.2 on the Statewide Property Inventory that we could not locate on Fish and Game's property listing.

- Fish and Game and the board's Statements of Changes in General Fixed Assets reported as of June 30, 2002, land of approximately $578.3 million and buildings and improvements of approximately $106.1 million, differences of $88.2 million and $17.1 million, respectively, greater than the property listings. The primary reason for these differences is that the accounting unit records transactions at year-end that may not have been finalized by June 30. For the year ended June 30, 2002, the accounting unit included land of approximately $146.4 million and buildings and improvements of approximately $17.9 million that may not have represented completed asset purchases.

- The accounting unit overstated land additions in the board's Statement of General Fixed Assets by at least $2.5 million by including cash grants given to a non-state entity. In addition, for fiscal year 2002–03, we determined that Fish and Game reported an additional $65.9 million in cash grants as land additions. Further, in fiscal year 2002–03, Fish and Game understated the gift value of land purchased by the board by $46.1 million.

In September 2004, we found that Fish and Game had not completed corrective action on these findings, but expects to do so by June 30, 2005.

Unless Fish and Game reconciles its property listings to the Statewide Property Inventory, reconciles its property listings to its Statement of General Fixed Assets, and reports complete and accurate information to the Controller's Office and General Services' Real Estate Services Division, the State's financial statements will be misstated and the Statewide Property Inventory will be incomplete and inaccurate.

CRITERIA

The California Government Code, Section 11011.15, requires each agency to furnish General Services with a record of each parcel of real property that it acquires and to update its real property holdings by July 1 each fiscal year. It also requires General Services to maintain a complete and accurate inventory of all real property held by the State. General Services includes Fish and Game's information in the Statewide Property Inventory. In addition, the State Administrative Manual, Section 7924, requires agencies to annually reconcile the amounts reported in the Statewide Property Inventory with the Statement of Changes in General Fixed Assets.

Additionally, the State Administrative Manual, sections 7463, 7977, and 8660, requires agencies to report to the Controller's Office in a Statement of Changes in General Fixed Assets all additions and deductions to real property funded by governmental funds. The Controller's Office includes this information in the State's financial statements.

RECOMMENDATIONS

To ensure that it reports complete and accurate information for the State's financial statements and the Statewide Property Inventory, Fish and Game should:

- Annually reconcile amounts it reports for the Statewide Property Inventory with its and the Wildlife Conservation Board's Statements of Changes in General Fixed Assets.

- Report in the Statement of Changes in General Fixed Assets real property that has been acquired on or before the end of the fiscal year.

- Report in the Statement of Changes in General Fixed Assets only real property acquired for the State.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Fish and Game concurs with the identified weaknesses in reporting and reconciling general fixed assets. It states that it is updating the database that captures property listings and has a plan to update and bring current its property database by June 2005. In addition, Fish and Game indicated that it no longer counts grants as land additions.

VARIOUS STATE DEPARTMENTS

Reference Number: 2004-19-3

CONDITION

State departments do not always report their employees' taxable fringe benefits and business expense reimbursements. Federal and state tax laws require that employers report income and related tax amounts for payments other than regular wages, including fringe benefits and business expense reimbursements. Fringe benefits—cash, property, or services received in addition to regular pay—are reportable as taxable income unless specifically excluded or deferred in Internal Revenue Service (IRS) regulations. Examples of such taxable reimbursements include mileage compensation for commuting or personal travel between home and office when employees must work overtime (overtime or callback mileage), payment for employees' meals when they must work overtime or travel for less than 24 hours without lodging, and the value of personal use of state vehicles.

The State Controller's Office (Controller's Office) informs state departments through its Payroll Procedures Manual and its Payroll Letters of the IRS and state requirements for reporting taxable fringe benefits and taxable business expenses. State departments must report these employee fringe benefits and business expense reimbursements to the Controller's Office by the 10th of the month following the month in which the payments were made. The Controller's Office then calculates and deducts the required taxes.

Despite these requirements, some departments did not consistently ensure that all employees' taxable benefits or taxable business expense reimbursements were being reported to the Controller's Office. To follow up on concerns we reported for fiscal year 2002–03, we reviewed the reporting of employee taxable benefits and reimbursements at ten state departments for January 2004 to June 2004. We reviewed from nine to 242 travel expense claims at each of these departments to determine whether the departments properly reported employee taxable reimbursements. However, not all of the travel expense claims we reviewed included claims for taxable fringe benefits.

Three state departments that we reviewed, the California Department of Education's California School for the Deaf–Fremont (Fremont), the Department of Fish and Game (Fish and Game), and the Department of Health Services (Health Services) continued to not always ensure that they reported taxable meals and/or taxable mileage reimbursements to the Controller's Office. The table shows the total number of travel expense claims with reportable items that we reviewed and the number of items we found that the departments did not report to the Controller's Office. Of the six meals that Fremont did not report, four were meals that it paid to a headquarters employee who was providing services on Fremont's behalf. However, neither Fremont nor the headquarters reported these taxable items to the Controller's Office. The remaining two items not reported were meals claimed by Fremont's employees. Fish and Game, after we communicated the results of our review, reported 43 of the 54 taxable meals and mileage reimbursements to the Controller's Office.

We also determined if those departments that issued vehicle home storage permits reported the personal use of state vehicles to the Controller's Office. Four state departments that we reviewed, the Department of Industrial Relations (Industrial Relations), the Department of Corrections (Corrections), Fish and Game, and Health Services did not always ensure that they reported the personal use of state vehicles to the Controller's Office. The table also shows the total number of employees with personal use of state vehicles that we reviewed that were not reported to the Controller's Office.

As we reported for fiscal years 2001–02 and 2002–03, Corrections informed us that its agents are exempt from reporting personal use of state vehicles based on its view of IRS regulations that exempt unmarked law enforcement vehicles if the employee uses the vehicle for law-enforcement functions. However, for the use to qualify as exempt, specific conditions must be satisfied and documented by actual facts and circumstances. For unmarked law enforcement vehicles to qualify, any personal use must be both authorized and incident to law enforcement functions such as reporting directly from home to a stakeout or surveillance site, or to an emergency situation. Travel directly from home to headquarters or from headquarters to home would not be exempt from reporting. Further, Corrections' financial information memorandum of April 2004 states that it cannot issue a blanket certification for all employee assigned vehicles nor automatically continue exemption status to a qualifying employee that later changes his assignment and no longer meets the IRS criteria. The memorandum also states that routine commuting by a peace officer in an unmarked law enforcement vehicle to and from home to a headquarters site does not qualify for exemption from reporting commute miles as a taxable benefit. Corrections had not fully documented the actual facts and circumstances of the daily travel of any of the agents that we tested.

Further, Industrial Relations, Fish and Game, and Health Services continued to lack adequate procedures to help ensure that they consistently and correctly report taxable fringe benefits. In addition, although at the time of our review Fremont did not have written procedures addressing who would report the benefits Fremont pays to headquarters employees performing services on its behalf, it subsequently revised its procedures to help ensure that it consistently and correctly reports these taxable fringe benefits.

Table

Reportable Items Reviewed That Were Not Reported to the Controller's Office in Fiscal Year 2003-04

		Items Not Reported		
Department/ Institution	Total Number of Travel Expense Claims With Reportable Items Reviewed	Overtime/ Callback Mileage	Meals for Less Than 24-Hours Travel/ Overtime Meals	Employees With Personal Use of State Vehicle*
Department of Industrial Relations	17	N/A	0	11
California School for the Deaf—Fremont	6	N/A	6	N/A
Department of Corrections	22	0	0	18
Department of Fish and Game	29	31	23	8
Department of Health Services	23	N/A	4	7
Totals	**97**	**31**	**33**	**44**

Note: Some travel expense claims contained more than one type of reportable item.

N/A = None included in travel expense claims reviewed or no vehicle home storage permits issued.

* Personal use of state vehicles is reported on documents separate from travel expense claims.

When state departments do not properly report their employees' taxable benefits and business expense reimbursements, the Controller's Office cannot calculate and withhold the related tax, as required by federal and state laws and regulations.

CRITERIA

The Controller's Office Payroll Procedures Manual, sections 120 through 176, provides procedures for reporting to the Controller's Office taxable fringe benefits and business expense reimbursements provided to state employees. These procedures are based on federal and state tax laws. The following benefits and payments included in this manual relate to our testing of agency compliance:

- Section 129.1 states that the use of state-owned or leased vehicles for personal commutes between home and office is reportable taxable income.
- Section 129.1.3 describes an IRS exemption for unmarked law-enforcement vehicles if the use of the vehicle is authorized and incident to law enforcement functions and the actual facts and circumstances are documented.
- Section 130.1.2 states that reimbursements to employees for commuting expenses, such as for expenses from commuting or personal travel between home and office, is considered taxable income. This includes callback and overtime mileage.
- Section 143.3 states that overtime meal compensation is reportable and constitutes taxable income.
- Section 145.1.2 states that meal reimbursement for less than 24-hour travel without lodging is taxable income. Simply stated, if an employee receives reimbursement for meals during travel in which there was no overnight stay, this reimbursement is taxable income.

RECOMMENDATION

To ensure proper reporting, all state departments should ensure that they have procedures established and implemented to properly report taxable fringe benefits and taxable employee business expense reimbursements.

DEPARTMENTS' VIEWS AND CORRECTIVE ACTION PLANS

The Department of Industrial Relations agrees with the finding. It indicates that it will develop written procedures to help ensure that taxable fringe benefits are properly reported.

The Department of Fish and Game agrees with the finding. It states that currently it does not have a centralized process to ensure compliance with the IRS rules, or to review and approve exemptions from reporting taxable benefits for personal use of state vehicles. Fish and Game indicates that it plans to update its desk procedures by June 30, 2005, so that there is a consistent justification and approval process and assurance that the IRS rules are being complied with. In addition, it states that it will communicate these procedures to staff through training or correspondence.

The Department of Health Services agrees with the finding. It states that it will endeavor to research the travel expense claims for proper reporting. It also states that it will establish and implement procedures for the proper reporting of personal use of state vehicles.

The California Department of Education agrees with the finding related to Fremont. It indicates that all six taxable fringe benefits were reported to the Controller's Office in September 2004.

The Department of Corrections agrees with the finding. It indicates that although its Financial Information Memorandum 2004–04, issued April 19, 2004, reiterates the IRS regulations, its interpretation exempted agents based on the description of the vehicle and the individual's specific duties and assignments. Further, its Accounting Management Branch plans to meet with the impacted units to discuss the reporting requirements and to assist them with implementing procedures for documenting the actual facts and circumstances of daily travel not reported to the Controller's Office. Finally, it states that it will amend its Financial Information Memorandum 2004–04 to include procedures on documenting exemptions to reporting taxable fringe benefits for personal use of qualified law enforcement vehicles.

DEPARTMENT OF PARKS AND RECREATION

Reference Number: 2004-19-4

CONDITION

For the fiscal years ending June 30, 2002, and June 30, 2003, we reported that the Department of Parks and Recreation (Parks and Recreation) did not have adequate procedures to account for and report its real property. Specifically, its acquisition unit did not report $3.4 million in ancillary costs for the assets acquired between July 2001 and June 2002. In its corrective action plan, Parks and Recreation had stated that it would train staff on reporting requirements for General Services' Statewide Property Inventory. It also indicated that it had taken steps necessary to ensure that it included ancillary costs of purchasing land in its reporting to General Services.

In November 2004 we followed up with Parks and Recreation to determine whether it reports ancillary costs to General Services for inclusion in the Statewide Property Inventory. We determined that the acquisition unit had not reported the $3.4 million in ancillary costs of land acquired in fiscal year 2001–02, and still does not report ancillary costs to General Services in a format that allows input into the Statewide Property Inventory system. Specifically, although the unit reported ancillary costs related to new acquisitions by project, it did not report them by parcel number that is necessary for General Services to record these costs in the Statewide Property Inventory.

In November 2004 we also determined that Parks and Recreation has not implemented our prior years' recommendation to reconcile the amounts reported in the Statewide Property Inventory with its Statement of Changes in General Fixed Assets. In December 2004, in an attempt to reconcile the two sources, Parks and Recreation acknowledged a difference of approximately $167 million between its and General Services' Statewide Property Inventory account balances for land.

In addition, for fiscal year 2002–03, we reported that the accounting unit had only reported to the State Controller's Office about $1.8 million of the $64 million gift value of land additions related to fiscal year 2001–02. We also reported that the acquisition unit had reported only

11 of 42 land additions acquired between July 2002 and June 2003 to General Services. During our November 2004 review, we determined that Parks and Recreation corrected these prior deficiencies.

Unless Parks and Recreation reports complete and accurate ancillary cost information to General Services, and periodically reconciles its Statement of Changes in General Fixed Assets with the Statewide Property Inventory records, the State's financial statements may be misstated and the Statewide Property Inventory will be incomplete and inaccurate.

CRITERIA

The State Administrative Manual, Section 8611, requires that all costs related to purchasing land be included in the capitalized amount. This includes ancillary costs such as legal and title fees, title search costs, grading, surveying, draining, etc.

The California Government Code, Section 11011.15, requires each agency to furnish General Services with a record of each parcel of real property that it possesses and to update its real property holdings by July 1 each fiscal year. It also requires General Services to maintain a complete and accurate inventory of all real property held by the State. General Services includes Parks and Recreation's information in the Statewide Property Inventory. In addition, the State Administrative Manual, Section 7924, requires agencies to annually reconcile the amounts reported in the Statewide Property Inventory with the Statement of Changes in General Fixed Assets.

RECOMMENDATIONS

We recommend that Parks and Recreation take the following actions:

- Report ancillary costs to General Services in a form acceptable for inclusion in the Statewide Property Inventory.

- Reconcile the amounts reported in the Statewide Property Inventory with its Statement of Changes in General Fixed Assets.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Parks and Recreation concurs with our findings and indicates that it is working with General Services to develop a process to include ancillary costs in the Statewide Property Inventory. Parks and Recreation also indicates that it has initiated a process to reconcile the amounts reported in the Statewide Property Inventory with its Statement of Changes in General Fixed Assets.

Compliance Issue Related to All Federal Grants

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IDENTIFYING PROGRAM EXPENDITURES

Reference Number:	2004-12-1
Federal Program:	All Programs
Category of Finding:	Reporting

CRITERIA

In our review of federal reports, we determined the following were among state and federal compliance requirements:

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133), requires that the State prepare a schedule showing total expenditures for the year for each federal program. Further, OMB Circular A-133 requires that the State identify and audit all high-risk Type A federal programs. Type A programs are those exceeding 15 percent of total federal program moneys the State expends during the fiscal year. The California Government Code, Section 13300, assigns the Department of Finance (Finance) the responsibility for maintaining a complete accounting system to ensure that all revenues, expenditures, receipts, disbursements, resources, obligations, and property of the State are properly tracked and reported.

CONDITION

Because of limitations in its automated accounting systems, the State has not complied with the provision of OMB Circular A-133 requiring a schedule showing total expenditures for each federal program. As a result, the schedule (beginning on page 147) shows total receipts, rather than expenditures, by program. Expenditure information is necessary to identify Type A programs. To ensure that we identified and audited all high-risk Type A programs, we reviewed accrual basis expenditures, which are identified manually, for all programs that we did not already plan to audit and that had cash receipts within 10 percent of the Type A program threshold. We identified two such programs. Our review of the expenditures of these programs showed that they did not exceed the Type A threshold. We also learned of a third program—Capitalization Grants for Drinking Water State Revolving Fund—whose cash receipts were not within 10 percent of the Type A threshold but whose reported expenditures exceeded it. Thus, this program was audited.

RECOMMENDATION

As priorities and resources permit, Finance should modify the State's accounting system to separately identify expenditures for all major programs.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Finance states that the State's accounting system will require substantial modification to compile expenditure information to meet all federal and State requirements. Because the State has limited resources, Finance has no plans at this time to enhance the State's accounting system or to implement a new system.

Compliance and Internal Control Issues Related to Specific Grants Administered by Federal Departments

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U.S. DEPARTMENT OF AGRICULTURE

Reference Number:	2004-3-12
Federal Catalog Number:	10.568
Federal Program Title:	Emergency Food Assistance Program (Administrative Costs)
Federal Award Numbers and Calendar Years Awarded:	7CA810CA8; 2003 7CA400CA2; 2004
Category of Finding:	Cash Management
State Administering Department:	Department of Social Services

CRITERIA

Our review of the Emergency Food Assistance Program identified the following compliance requirement related to cash management:

The Code of Federal Regulations, Title 31, Part 205, Subpart B, provides the cash management requirements for federal programs not covered in the Cash Management Improvement Act agreement between the U.S. Department of the Treasury and the State. Section 205.33 requires the State to limit cash transfers from the U.S. Department of the Treasury to the minimum amounts needed.

CONDITION

The Department of Social Services (Social Services) did not always limit cash transfers of federal funds to the minimum amounts needed for the Emergency Food Assistance Program. In June 2004 Social Services transferred to the program two advances totaling $1.9 million in federal funds. According to Social Services, it incorrectly transferred these advances based on May and June estimates to cover monthly expenditures for June. As a result, Social Services had excess monthly balances of federal funds in the State's account from July 1, 2004, through September 23, 2004. The excess balances ranged from $49,000 to $1.3 million more than the Emergency Food Assistance Program needed to cover its monthly expenditures.

RECOMMENDATION

Social Services should limit transfers of federal funds to the minimum amounts needed for the Emergency Food Assistance Program. To accomplish this objective, Social Services should ensure that it follows its procedure to limit advances to monthly estimates and that it promptly liquidates excess cash balances.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The Department agrees with the recommendation. As a result of previous findings, the Department's estimating methodology was improved to more realistically reflect the cash need for disbursements at the end of the State fiscal year. In June 2003, however, an advance for June 2003 was duplicated in error using May 2003 expenditures. Staff thought the data to be June 2003 actual disbursements and drew the additional funds accordingly. New staff will be trained for the forthcoming year-end and will review the processes associated with the end of year advances to minimize the amount of funds requested.

Reference Number:	2004-13-2
Federal Catalog Number:	10.558
Federal Program Title:	Child and Adult Care Food Program
Federal Award Numbers and Calendar Years Awarded:	7CA300CA3; 2003 7CA300CA3; 2004
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Education

CRITERIA

Our review of the Child and Adult Care Food Program (food program) determined that the following requirement relates to subrecipient monitoring:

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, Section 400(d), requires the State to identify federal award information to subrecipients at the time of the award. This includes such information as the Catalog of Federal Domestic Assistance title and number, award name and number, and name of the federal agency.

CONDITION

The Department of Education (Education) did not adequately fulfill its subrecipient monitoring responsibilities for the food program. Specifically, the application formats Education uses for its child care centers and day care homes did not contain all the required federal award information. After we reported the same issue in March 2004 for the fiscal year 2002–03 audit, Education revised its child care center applications in May 2004 to include the required information. When Education does not identify the federal award information, it cannot ensure that subrecipients of the Food Program correctly identify all their federal grant awards. As a result, subrecipients' independent auditors, who must conduct audits in accordance with U.S. Office of Management and Budget Circular A-133, may not be aware of all grants they must consider for audit. The State uses the independent audits as one method to monitor subrecipients' compliance with applicable federal requirements and program goals.

RECOMMENDATION

Education should ensure that it identifies and provides all required federal award information to all subrecipients of the food program at the time of the awards.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION

Education revised its adult day care center, child care center, and day care home agreements and renewal applications to include the required federal award information.

Reference Number:	2004-13-7
Federal Catalog Number:	10.557
Federal Program Title:	Special Supplemental Nutrition Program for Women, Infants, and Children
Federal Award Numbers and Calendar Years Awarded:	7CA700CA7; 2002 7CA700CA7; 2003
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Special Supplemental Nutrition Program for Women, Infants, and Children (WIC Program) identified the following compliance requirements related to subrecipient monitoring:

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133), describes the audit requirements for recipients of federal funds. Sections 200 and 320 require subrecipients spending $300,000 or more annually in federal awards to submit audit reports to the State when the reports address findings related to the federal awards that the State administers. Audit reports are due within nine months of the subrecipient's audit period. In cases of continued inability or unwillingness of the subrecipient to have the required audits, the OMB Circular A-133, Section 225 requires the State to take appropriate action using sanctions to ensure compliance. The Circular A-133 also requires the State to issue management decisions on audit findings within six months of receiving audit reports and to ensure that subrecipients take appropriate and timely corrective action.

Further, the Department of Health Services (Health Services) has established guidelines requiring its Maternal and Child Health (MCH) Branch to send letters to its local agencies reminding them of the due dates for submitting their audit reports. Health Services' internal guidelines also require the MCH Branch to send late notices 30, 60, and 90 days after the due date of the reports.

CONDITION

Health Services did not always promptly receive all audit reports from its nonprofit subrecipients. Specifically, Health Services received audit reports that were 20 to 268 days late from three of the 20 subrecipients we reviewed who participated in its WIC Program. Health Services did not always receive the required audit reports on time because it did not consistently adhere to its process for obtaining these reports. For the three subrecipients that submitted their reports late, Health Services sent reminder letters and late notices after the due dates and within three days of each other, reducing the effectiveness of the reminder letters and late notices. Additionally, rather than imposing any sanctions, Health Services continued to fund the one subrecipient that was unable to submit its audit report until 268 days after the federal due date. Failure to obtain audit reports promptly may prevent early detection and correction of deficiencies in services provided by subrecipients.

Moreover, Health Services did not require corrective action plans from two of the five subrecipients whose audit reports we reviewed, even though the reports identified material findings related to the WIC Program. Health Services sent letters to the subrecipients indicating that it had completed its review, but it did not request any type of corrective action plan. Discussions with staff from each of the three functional areas involved in tracking and monitoring audit reports from subrecipients revealed that they hold conflicting views regarding which functional area is responsible for identifying when a corrective action plan is needed. By not requiring corrective action plans, Health Services cannot ensure that subrecipients correct deficiencies.

RECOMMENDATIONS

Health Services should ensure that its staff members follow its process for following up on delinquent audit reports from nonprofit subrecipients. Further, it should ensure that it makes clear which functional area is responsible for identifying when a corrective action plan is needed and obtain a plan when appropriate. Health Services should also establish a process to impose sanctions, such as withholding payments, for subrecipients who are continually unable or unwilling to provide the required audit reports.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

1. **Follow internal process for following up on delinquent audit reports from nonprofit subrecipients.**

   Concur. MCH and Health Services program staff recognizes that it is important to adhere to the process for obtaining the audit reports and has developed a thorough audit tracking system in order to do so; however, staffing shortages interrupted the ongoing management of the spreadsheets for a period of time. With a new supervisor and staff in place, the process is now back on course.

2. **Clarify which functional area is responsible for identifying when a corrective action plan is needed and obtain a plan when appropriate.**

   Concur. MCH and Health Services program staff recognizes that it is important to clarify which program is responsible for approving technical corrective action plans involving accounting issues and has done so for the most part. MCH staff routinely handles the 30, 60 and 90-day late notices and sends out audit report approval letters. MCH staff also communicates regularly with Health Services programs to discuss agencies that experience fiscal problem or that have outstanding audits. The challenge is that some Health Services programs do not have the resources to track their own program audits and most do not have the ability to respond to technical accounting issues. Staff from Health Services programs are working together to clarify how to address this problem.

3. **Establish a process to impose sanctions, such as withholding payments, for subrecipients who are continually unable or unwilling to provide the required audit reports.**

   Concur. Health Services programs have sanction language in their warning letters and staff has used it in the past to gain cooperation from programs. The subrecipient that did not submit its audit report for 268 days, Watts Healthcare Foundation, was involved in bankruptcy proceedings. In addition to MCH sending the late notices, WIC staff sent a probation-warning letter on September 2, 2003. Health Services received the audit once the agency's bankruptcy was resolved and therefore no sanction was imposed. While one clear priority is to ensure that audit reports are submitted in a timely manner, it is of equal importance that services to low-income mothers and children are maintained.

Health Services recognizes that it is a priority to track and monitor compliance with annual audits for fiscal compliance and has developed a detailed system for doing so. This example illustrates the equal importance of maintaining access to services for our low-income mothers and children.

The WIC Program follows the following procedure below to track audit reports:

- Contacting the local agency WIC program coordinator by phone to inform them that the audit report is late so they can investigate the situation. This has been effective in the past, as the agency management has reported back to WIC on the status of the audit report.

- Mailing the probation letter to formalize the audit request and continuing to monitor the response.

- Sanctioning the subrecipient following noncompliance to the probation letter.

Health Services programs continue to work with MCH to further clarify the functional roles and identify resources to improve performance in this area.

Reference Number:	2004-13-10
Federal Catalog Number:	10.557
Federal Program Title:	Special Supplemental Nutrition Program for Women, Infants, and Children
Federal Award Numbers and Calendar Years Awarded:	7CA700CA7; 2002 7CA700CA7; 2003
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Special Supplemental Nutrition Program for Women, Infants, and Children (WIC Program) identified the following compliance requirements related to subrecipient monitoring:

The Code of Federal Regulations, Title 7, Section 246.19(b)(4), requires the State to promptly notify a local agency of any finding resulting from a monitoring review, and the State must require the local agency to submit a corrective action plan within 60 days of receipt of the State's findings. Finally, this section requires the State to monitor the local agencies' implementation of the corrective action plan.

CONDITION

In fiscal year 2002–03, we reported that the Department of Health Services (Health Services) did not comply with its internal policy requiring it to issue letters of findings to the local agencies within 60 days of the exit conferences. We recommended that Health Services comply with its internal policy; we also recommended that if Health Services believes this deadline is too restrictive, it should consider revising its internal policy. However, rather than revising the policy and establishing a more reasonable deadline, Health Services eliminated the 60-day deadline from its internal policies.

Although it no longer has a 60-day requirement for fiscal year 2003–04, we reviewed the length of time it took Health Services to send letters of findings. We found that Health Services took more than 90 days and as much as 152 days following the exit conferences to send letters of findings to 10 of the 35 local agencies that we reviewed that had findings. Because of the significant amount of time it took to send these letters of findings, we believe it is important that Health Services reestablish a deadline to ensure that it meets the federal requirement of promptly notifying local agencies of findings and requesting corrective action plans. Finally, we also noted that nine of the 35 local agencies for which Health Services reported findings did not submit their corrective action plans within 60 days, as required. Specifically, nine of the local agencies submitted the corrective action plans between one and 142 days late. For another three local agencies required to submit corrective actions plans, Health Services could not provide evidence of when it received the plans; therefore, we were unable to determine whether Health Services received the plans within 60 days. As a result of these weakneses, Health Services cannot always ensure that its subrecipients correct deficiencies promptly.

RECOMMENDATIONS

To ensure that it complies with applicable federal laws and regulations, Health Services should reestablish a reasonable deadline for issuing letters of findings to local agencies to ensure that they submit corrective action plans promptly. Health Services should also work with the local agencies to gain assurance that they submit corrective action plans promptly.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

1. **Reestablish a reasonable deadline for issuing letters of findings to local agencies to ensure that they submit corrective action plans promptly.**

   Do not concur. The 60-day target date for releasing a Program Evaluation letter of findings to the local agency was removed from the WIC Program Evaluation Training Manual, to be consistent with WIC Program Manual (WPM) Policy 150-10. This policy states, "A letter summarizing the findings and recommendations of the program evaluation team is forwarded to the local agency following the program evaluation". There is no time frame established in the WPM for a letter, because at the time a letter is released, DHS has already complied with the intent of the federal requirement.

   DHS is in compliance with 7CFR246.19(b)(4) regarding the prompt notification to the local agency of the monitoring review findings. At the conclusion of the Program Evaluation, a formal Exit Conference is held with local agency management staff. During this Exit Conference, a comprehensive, itemized summary of the PE findings is presented by the PE team and thoroughly discussed. A typical Exit Conference lasts from one to two hours. The above referenced federal citation, states "The State agency must promptly notify a local agency of any finding in a monitoring review that the local agency did not comply with program requirements". The federal regulation is silent relative to the notification being provided orally or in writing. DHS maintains that the formal exit conference immediately following the program review more than satisfies the intent of the regulation.

   Requirements aside, DHS concurs that providing a written summary of the evaluation findings within 90 days is a reasonable target, and state staff will work to strengthen its procedures for assuring timely completion, review and release of the letters.

2. **Work with the local agencies to gain assurance that they submit corrective action plans promptly**

   Concur. State staff will issue reminders to local agencies prior to the due date in order to assure that they submit their Corrective Action Plans promptly.

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

If Health Service's position is that it is promptly notifying local agencies of findings as part of the formal exit conferences, we would then expect the local agencies to submit corrective action plans within 60 days of the exit conference rather than 60 days of issuing the letter of findings.

Reference Number:	2004-13-15
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Social Services

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of the Food Stamps program and the State Administrative Matching Grants for Food Stamp Program (Food Stamps programs) identified the following requirements relating to subrecipient monitoring:

The Code of Federal Regulations, Title 7, Section 275.1, requires the State to have a system for monitoring and improving its administration of the Food Stamps programs, particularly the accuracy of eligibility and benefit determinations. Further, Section 275.5 requires the State to conduct management evaluation (ME) reviews regularly based on project area size: once every year for large project areas, once every two years for medium project areas, and once every three years for small project areas. In California, project areas are defined as counties. Finally, the procedures of the Department of Social Services (Social Services) indicate that it conducts three types of reviews to meet these requirements: a claims management review, a California Food Assistance Program review (program review), and a civil rights review.

CONDITION

Social Services is not fulfilling all its monitoring responsibilities for the Food Stamps programs. For federal fiscal year 2003–04, although Social Services performed the required annual program reviews of seven large counties, it did not conduct any of the claims management reviews and two of the civil rights reviews required for those counties. Because it is not conducting annual reviews of the large project areas as required by the federal regulations, Social Services has less assurance that subrecipients are complying with applicable laws and regulations.

According to an official of the U.S. Department of Agriculture, he has already identified that Social Services is not performing the required annual and biennial reviews, and he is working with Social Services to develop a plan to perform alternative procedures. However, the official also indicated that if Social Services' review efforts are not increased, it could be subject to fiscal sanctions.

RECOMMENDATION

To ensure that its subrecipients are complying with applicable laws and regulations, Social Services should continue to work with the U.S. Department of Agriculture to develop a plan to sufficiently monitor the activities of its subrecipients. However, if it is unable to develop a plan that satisfies the U.S. Department of Agriculture, it should perform the required reviews as outlined in the federal regulations.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The California Department of Social Services (CDSS) concurs with this audit finding. CDSS is training staff to conduct reviews and will attempt to comply in future years. CDSS's corrective action plan is to continue working with the United States Department of Agriculture, Food and Nutrition Service to resolve these issues related to management evaluation reviews.

U.S. DEPARTMENT OF AGRICULTURE

Federal Catalog Number:	10.551
Federal Program Title:	Food Stamps
Year Awarded:	State fiscal year 2003–04

Federal Catalog Number:	10.561
Federal Program Title:	State Administrative Matching Grants for Food Stamp Program
Federal Award Number and Calendar Year Awarded:	7CA400CA4; 2003

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Reference Number:	2004-13-12
Federal Catalog Number:	14.239
Federal Program Title:	HOME Investment Partnerships Program
Federal Award Number and Calendar Year Awarded:	M03-SG060100; 2003
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Housing and Community Development

CRITERIA

Our review of the HOME Investment Partnerships Program (HOME) identified the following compliance requirements related to subrecipient monitoring:

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133), describes the requirements the State must follow when it awards federal funds to subrecipients. Section 400(d)(4) requires the State to ensure that each subrecipient spending $300,000 or more in federal assistance in fiscal year 2002–03 meets applicable audit requirements, including submitting an audit report to the State within nine months following the end of the audit period. Further, Section 400(d)(5) requires the State to issue a management decision on audit findings within six months after receipt of a subrecipient's audit report and to ensure that the subrecipient takes appropriate and timely corrective action.

CONDITION

Housing and Community Development (Housing) lacks an adequate system to ensure that it promptly receives all audit reports from nonprofit subrecipients required to submit them. It also lacks an adequate system to ensure that it issues management decisions on reported findings. Specifically, we found that Housing did not receive the required audit reports for two of the five nonprofit subrecipients that received more than $300,000 in HOME funds. For one of the two subrecipients, Housing has not taken any action to remind the subrecipient that its audit report is late. Although Housing sent a letter in August 2004 to the other subrecipient reminding it that its report is late, Housing has not taken further action.

Additionally, Housing did not always issue a management decision on audit findings for local governments within six months of receiving audit reports from them and did not ensure that they took appropriate and timely corrective action on the audit findings. Specifically, Housing has not issued management decisions for three of five local governments that had audit findings for fiscal year 2002–03, even though it received these reports more than six months ago. In addition, Housing has not issued management decisions more than a year after receiving audit reports for four of five local governments that had audit findings for fiscal year 2001–02.

Without effective systems to ensure that subrecipients submit audit reports and take appropriate and timely corrective actions to resolve audit findings, Housing has reduced assurance that its nonprofit subrecipients are spending HOME funds according to applicable laws and regulations.

RECOMMENDATIONS

Housing should establish procedures for ensuring that subrecipients submit audit reports as required. Further, for subrecipients with audit findings, Housing should issue management decisions within six months of receiving the subrecipients' audit reports and ensure that subrecipients take appropriate and timely corrective action on audit findings.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Housing concurs that current procedures should be improved. Housing currently has procedures in place for subrecipient monitoring, including the sending of letters to subrecipients requesting audit reports as required. Current procedures will be expanded to incorporate a more extensive tracking system of subrecipients, timely follow-up of non-responses, regular management meetings regarding the compliance status of subrecipients, etc. In addition, non-compliant subrecipients who have not submitted required audit reports will be subject to performance point reductions in the evaluation of their HOME applications until the required audit report is submitted (Title 25 California Code of Regulations, Section 8212). Non-compliant nonprofit subrecipients will not be certified as eligible Community Housing Development Organizations to participate in the State HOME Program (Title 25 California Code of Regulations, Section 8204.1).

Reference Number:	2004-1-4
Federal Catalog Number:	16.575
Federal Program Title:	Crime Victim Assistance
Federal Award Numbers and Calendar Years Awarded:	2000-VA-GX-0006; 2000 2001-VA-GX-0006; 2001 2002-VA-GX-0006; 2002
Category of Finding:	Activities Allowed, Allowable Costs, Cash Management, Eligibility, Period of Availability, Reporting
State Administering Department:	Office of Emergency Services

CRITERIA

Our review of the Crime Victim Assistance program identified the following compliance requirements related to activities allowed, allowable costs, cash management, eligibility, period of availability, and reporting:

The Code of Federal Regulations, Title 28, Section 66.41, requires the Office of Emergency Services (Emergency Services) to submit financial status reports showing all program outlays and program income. This section also requires Emergency Services to submit federal cash transaction reports, which enable the federal government to obtain information on the disbursements or outlays of each grant. Additionally, the final program guidelines established by the U.S. Department of Justice's Office of Justice Programs require Emergency Services to submit specific grant performance data for the Crime Victim Assistance program by December 31 of each year. These guidelines also require Emergency Services to use appropriate accounting and auditing procedures to maintain records that reflect sound fiscal control, proper management, and efficient disbursement of funds for the Crime Victim Assistance program.

CONDITION

Emergency Services cannot ensure that all fiscal year 2003–04 expenditure and revenue transactions applicable to the Crime Victim Assistance program grants awarded for federal fiscal years 2000, 2001, and 2002 were recorded in the accounting records. As a result, Emergency Sevices cannot determine whether the federal financial status reports submitted for these grants are accurate. Moreover, because of the uncertainty of the completeness of Emergency Services' accounting records, we could not be sure that we subjected all transactions related to these grants to testing. Consequently, we are unable to conclude that Emergency Services or the former Office of Criminal Justice Planning (OCJP), which administered the grants until it closed in December 2003, complied with federal laws, regulations, and requirements for activities allowed, allowable costs, cash management, eligibility, period of availability, and reporting.

According to Emergency Services, the former OCJP failed to record numerous transactions in the accounting records. In March 2004, Emergency Services informed the U.S. Department of Justice that it had not had the opportunity to verify the accuracy of the final financial status reports for the Crime Victim Assistance program as well as other federal programs previously administered by the former OCJP and that it would take several months to complete the verification process. Subsequently, Emergency Services contracted with the Department of Finance to determine whether grant and accounting information was appropriately and accurately transferred from the former OCJP to Emergency Services and to reconstruct the financial accounting records. The Department of Finance expects to complete its work in February 2005. According to Emergency Services, the federal Department of Justice is not releasing the funds remaining in the 2000 and 2002 grants until Emergency Services can provide accurate reports. As of December 2003, when the former OCJP prepared closeout reports for these grants, there was approximately $2.4 million in available federal funds remaining in the three grants.

Finally, Emergency Services included incorrect performance data on the annual report submitted to the U.S. Department of Justice. Among other things, Emergency Services is required to provide data showing the number of victims served in a variety of categories. We reviewed the documentation supporting the data included in the report for five categories and determined that Emergency Services reported inaccurate data for each of the five categories. For example, Emergency Services' performance report indicated that services were provided to 145,924 victims of domestic violence. However, the supporting documentation showed that services were actually provided to 132,537, a difference of 13,387.

RECOMMENDATIONS

Emergency Services should submit revised financial status reports to the U.S. Department of Justice for the Crime Victim Assistance program when the Department of Finance completes its reconstruction of the accounting records. Further, based on the reconstructed accounting records, Emergency Services should determine if federal reimbursements received by the State for the Crime Victim Assistance program exceeded the amount of costs incurred for allowable activities and then take appropriate actions. Finally, Emergency Services should implement controls to ensure that performance data included in the annual reports submitted to the federal government is accurate.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Emergency Services is in agreement with the findings in this audit report. The Department of Finance has completed its contracted work effort related to the former OCJP accounting reconstruction and grant compliance review. Emergency Services will begin reviewing the contract work and posting necessary adjustments to the former OCJP accounting records beginning in February 2005. This process will take approximately 3-4 months to complete at which time the required financial status reports will be submitted to the federal government.

Additionally, the progress reports submitted by subgrantees to collect information for our performance report will be revised for field use this year and the subgrantees will be required to begin using them next fiscal year. This will allow them to revise/expand their management information systems to incorporate the changes and collect the data in the manner in which the revised progress report will require.

U.S. DEPARTMENT OF JUSTICE
U.S. DEPARTMENT OF HOMELAND SECURITY

Reference Number: 2004-13-9

Category of Finding: Subrecipient Monitoring

State Administering Department: Office of Emergency Services

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of the Crime Victim Assistance, State Homeland Security Grant, Public Assistance Grants, and Hazard Mitigation Grant programs determined the following compliance requirements related to subrecipient monitoring:

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133), requires subrecipients spending $300,000 or more in federal assistance in fiscal year 2002–03 to submit audit reports to the State within nine months of the end of their fiscal year. The State is responsible for notifying subrecipients of the applicable audit requirements. Additionally, the State requires subrecipients to submit audit reports to the State Controller's Office (Controller's Office) or the appropriate state department so that corrective action can be taken on reported deficiencies. If an audit finds that a subrecipient has failed to comply with federal program requirements, OMB Circular A-133 also requires the State to issue a management decision regarding the resolution of the audit finding within six months of receiving the audit report and to ensure that the subrecipient proceeds with timely corrective action.

Addtionally, the United States Code, Title 31, Section 7502, requires the State to monitor subrecipients' use of federal awards through site visits, limited scope audits, or other means. To comply with this requirement, Emergency Services' Criminal Justice Programs Division conducts periodic site visits of subrecipients of the Crime Victim Assistance program.

CONDITION

The Office of Emergency Services (Emergency Services) did not adequately monitor subrecipients of funds for the Crime Victim Assistance, State Homeland Security Grant, Public Assistance Grants, and Hazard Mitigation Grant programs. Specifically, during fiscal year 2003–04, Emergency Services did not ensure that it received or reviewed audit reports submitted by private nonprofit organizations that expended $300,000 or more in federal assistance in fiscal year 2002–03 and, therefore, could not follow up on identified findings. For example, Emergency Services' Criminal Justice Programs Division has not reviewed 143 audit reports it has received in accordance with OMB Circular A-133 since July 2000 from nonprofit subrecipients of the Crime Victim Assistance program.

Emergency Services also did not follow up on findings for audit reports provided by the Controller's Office regarding local governmental subrecipients that spent $300,000 or more in federal assistance in fiscal year 2002–03. The Controller's Office receives audit reports for local governmental entities and, if the reports contain findings, forwards copies to the state agencies responsible for administering the programs to follow up with the local governmental subrecipients to ensure that identified weaknesses are corrected.

Because Emergency Services does not ensure that audit reports are received and does not review audit reports it does receive, it cannot ensure that subrecipients are complying with federal program requirements or that weaknesses identified in the audit reports are promptly corrected. According to Emergency Services' chief of the Grants Management Section, Disaster Assistance Division, and the manager of the Grants Analysis Unit, staffing limitations and redirection of existing staff prevented Emergency Services from tracking and reviewing the audit reports required by OMB Circular A-133.

Finally, Emergency Services' Criminal Justice Programs Division does not adequately follow up on the results of site visits it conducts. Specifically, for four of 10 on-site fiscal reviews it conducted, we found that it either failed to follow up or did not document that it had followed up with subrecipients to ensure that deficiencies identified during the site visits were corrected. Consequently, Emergency Services cannot ensure that its subrecipients correct deficiencies promptly.

RECOMMENDATIONS

Emergency Services should promptly review audit reports submitted by private nonprofit subrecipients in accordance with OMB Circular A-133. In addition, Emergency Services should follow up on all reported audit findings concerning private nonprofit and local governmental subrecipients.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Emergency Services agrees that it did not fulfill all pass-through agency requirements for all grants included in OMB Circular A-133. During the past 12 months, Emergency Services has experienced a decrease in staffing levels, the mid-year assimilation of the former Office of Criminal Justice Planning, and a steadily increasing workload related to new Homeland Security grant programs.

Emergency Services has programmatic procedures in place to ensure that subrecipients comply with federal program regulations and administrative requirements. However, Emergency Services recently reorganized and is in the process of evaluating priorities, workloads and staffing needs as a whole. Emergency Services will consider its OMB Circular A-133 subrecipent monitoring role during this evaluation.

We also acknowledge the finding regarding site visits and have developed topical areas related to Site Visits and Correction Action Plans for tracking purposes in a spreadsheet on the Victim Services Branch Sharedrive to help staff with follow up activities and to serve as a mechanism for documentation. Each Section is responsible for updating the spreadsheet.

We would also like to point out that after the Budget Act was signed August 11, 2003 abolishing the Office of Criminal Justice Planning, time and attention was devoted into closeout procedures resulting in revising approximately 475 subgrant awards to include objectives and activities as well as budgets to reflect an end date of September 30, 2003. Year end progress reports collected from all subgrantees were also required as part of the close out process. This major effort had an impact on routine activities such as site visits and follow up with deficiencies and corrective action plans occurred during this time. This was also complicated by the State Budget crisis that prevented staff from performing site visits to identify and follow up on deficiencies.

U.S. DEPARTMENT OF JUSTICE

Federal Catalog Number:	16.575
Federal Program Title:	Crime Victim Assistance
Federal Award Numbers and Calendar Years Awarded:	2000-VA-GX-0006; 2000 2001-VA-GX-0006; 2001 2002-VA-GX-0006; 2003 2003-VA-GX-4025; 2003

Federal Catalog Number:	16.007
Federal Program Title:	State Domestic Preparedness Equipment Support
Federal Award Numbers and Calendar Years Awarded:	2000-TE-CX-0166; 2000 2002-TE-CX-0088; 2002 2002-TE-CX-0133; 2002 2003-TE-TX-0167; 2003 2003-MU-T3-0035; 2003 2004-GE-T4-0045; 2004

U.S. DEPARTMENT OF HOMELAND SECURITY

Federal Catalog Number:	97.036 (formerly 83.544)
Federal Program Title:	Public Assistance Grants
Year Awarded:	State fiscal year 2003-04

Federal Catalog Number:	97.039 (formerly 83.548)
Federal Program Title:	Hazard Mitigation Grant
Year Awarded:	State fiscal year 2003-04

U.S. DEPARTMENT OF LABOR

Reference Number:	2004-2-1
Category of Finding:	Allowable Costs and Cost Principles
State Administering Department:	Employment Development Department

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of federal programs at the Employment Development Department (EDD) identified the following compliance requirements related to allowable costs and cost principles:

The U.S. Office of Management and Budget Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments* (OMB Circular A-87), Attachment A, Section C, states that for costs to be allowable under federal awards, they must be allocable to federal awards under the provisions of this circular. This is the case if the goods or services involved are chargeable or assignable to a grant in accordance with the relative benefits achieved. Section C also states that when an accumulation of indirect costs will ultimately result in charges to a federal award, a cost allocation plan will be required, as described in OMB Circular A-87, Attachments C, D, and E. OMB Circular A-87, Attachment E, Section A, states that indirect costs are incurred for common or joint purposes. These costs benefit more than one cost objective and cannot be readily identified with a particular final cost objective without effort disproportionate to the results achieved.

In addition, OMB Circular A-87, Attachment B, Section 8, states that charges to federal awards for salaries and wages will be based on payrolls documented according to the generally accepted practice of the governmental unit and approved by a responsible official of the governmental unit. EDD's employee time sheets include a signature block for the person approving an employee's time.

CONDITION

EDD allocated six of 10 operating expense and equipment (OE&E) transactions we reviewed, even though it had not obtained federal approval to do so as part of its indirect cost rate proposal. The six allocated transactions included OE&E expenses such as equipment rental, repair, and maintenance; software purchasing and maintenance; and automobile maintenance and repairs. According to EDD, it used the allocation codes to distribute OE&E costs that it could not specifically identify with a particular federal program. Consequently, EDD should have included and distributed these allocated costs under its indirect cost rate proposal.

Costs related to the six test items totaled $116,364. Although we could not determine the amount of allocated costs charged to the federal programs we audited, according to EDD, in fiscal year 2003–04 it used 70 allocation codes to distribute personnel costs and 88 allocation codes to distribute OE&E costs totaling more than $60 million and $31 million, respectively. These allocated costs were not included in EDD's indirect cost rate proposal. In total the allocated costs represented 7.4 percent of EDD's estimated total state operations expenditures of more than $1.2 billion for fiscal year 2003–04. When EDD does not distribute indirect costs under an indirect cost rate proposal, it is less likely to adequately demonstrate that these costs are distributed in accordance with the relative benefits received by its various federal programs. We reported a similar finding during our audits for fiscal years 1998–99 through 2002–03.

Further, for two of the 30 payroll expenditures we reviewed, the signature block for approval of the related employee time sheet was blank. When a time sheet is not approved, there is less assurance that reported time accurately reflects the work of the employee. The payroll expenditures from these two time sheets totaled $5,189. We reported a similar condition during our audits for fiscal years 2001–02 and 2002–03.

RECOMMENDATIONS

In its indirect cost rate proposal, EDD should include documentation to substantiate its use of indirect costs for such expenditures as equipment, software, and automotive expenses. EDD should also reiterate to its staff that supervisors must approve employee time sheets.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

1. The EDD has convened a workgroup to ensure the upcoming Indirect Cost Rate Proposal (March 2005) includes proper documentation for allocated costs. Currently, the workgroup is exploring (1) alternatives to allocation codes and (2) how to strengthen the existing procedure to justify allocation codes that are in use.

2. In May 2004 and September 2004, EDD sent e-mail notices to all staff explaining "Employee Time Reporting Responsibilities." Among other information, these e-mail notices reminded all staff that time sheets (1) must have an approval signature, (2) must be free of obliterations, and (3) will be monitored on a random sample basis. The notices further stated that significant instances of non-compliance will be reported to the appropriate Deputy Director for a resolution. In July 2004, the EDD began monitoring and working with specific entities to help ensure compliance.

U.S. DEPARTMENT OF LABOR

Federal Catalog Number:	17.207
Federal Program Title:	Employment Services
Federal Award Number and Calendar Year Awarded:	ES-13042-03-55; 2003

Federal Catalog Number:	17.801
Federal Program Title:	Disabled Veterans' Outreach Program
Federal Award Number and Calendar Year Awarded:	E-9-5-4-5085; 2003

Federal Catalog Number:	17.804
Federal Program Title:	Local Veterans' Employment Representative Program
Federal Award Number and Calendar Year Awarded:	E-9-5-4-5085; 2003

Federal Catalog Number:	17.225
Federal Program Title:	Unemployment Insurance
Federal Award Number and Calendar Year Awarded:	UI-13546-04-55; 2003

Federal Catalog Number:	17.258
Federal Program Title:	WIA Adult Program
Federal Award Number and Calendar Year Awarded:	AA-12914-03-50; 2003

Federal Catalog Number:	17.259
Federal Program Title:	WIA Youth Activities
Federal Award Number and Calendar Year Awarded:	AA-12914-03-50; 2003

Federal Catalog Number:	17.260
Federal Program Title:	WIA Dislocated Workers
Federal Award Number and Calendar Year Awarded:	AA-12914-30-50; 2003

Reference Number: 2004-9-1

Category of Finding: Procurement

State Administering Department: Employment Development Department

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of federal programs at the Employment Development Department (EDD) identified the following compliance requirements relating to procurement:

The Code of Federal Regulations, Title 29, Section 97.36, requires states procuring property and services under a federal grant to follow the same policies and procedures they use for procurements from their nonfederal funds. The State Administrative Manual (SAM), Section 8711.3, states it is the responsibility of the agency accounting office to verify invoices from transportation companies to verify that the transportation service was furnished and the rate charged is correct. In addition, Section 8422.114 of the SAM requires that a passenger's copy of an airline ticket be compared with the airline invoice to determine the propriety of the charge.

CONDITION

EDD does not appropriately review invoices for purchases of airline tickets. Specifically, in December 2003 EDD used more than $36,000 in federal funds to help pay an invoice from a credit card company that EDD employees use to purchase airline tickets. However, though EDD receives a detailed invoice of the airline tickets purchased, as well as any related fees, it does not compare the employee's copy of the airline ticket to the invoice to ensure that the charges are appropriate, as required by the SAM. According to EDD's manager of administrative payments, EDD does not have a procedure in place to perform this comparison. Thus, its failure to compare copies of airline tickets to invoices likely occurred for similar payments totaling more than $182,500 made in other months of fiscal year 2003–04. By not performing this comparison, EDD has reduced assurance that it is paying for services it actually received and that the payments are appropriate.

RECOMMENDATION

EDD should ensure that it compares the employee's copy of an airline ticket with detailed invoices to verify the propriety of the charge.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The EDD is currently preparing an EDD Travel Bulletin that will strengthen the review of airline charges. The Travel Bulletin will require all EDD offices to review monthly spreadsheets detailing airline travel charged to EDD. Offices will be required to follow-up on items that are inappropriately charged or are for non-approved EDD travel.

U.S. DEPARTMENT OF LABOR

Federal Catalog Number:	17.207
Federal Program Title:	Employment Service
Federal Award Number and Calendar Year Awarded:	ES-13042-03-55; 2003

Federal Catalog Number:	17.801
Federal Program Title:	Disabled Veterans' Outreach Program
Federal Award Number and Calendar Year Awarded:	E-9-5-4-5085; 2003

Federal Catalog Number:	17.804
Federal Program Title:	Local Veterans' Employment Representative Program
Federal Award Number and Calendar Year Awarded:	E-9-5-4-5085; 2003

Federal Catalog Number:	17.225
Federal Program Title:	Unemployment Insurance
Federal Award Number and Calendar Year Awarded:	UI-113536-04-55; 2003

Federal Catalog Number:	17.258
Federal Program Title:	WIA Adult Programs
Federal Award Number and Calendar Year Awarded:	AA-12914-03-50; 2003

Federal Catalog Number:	17.259
Federal Program Title:	WIA Youth Activities
Federal Award Number and Calendar Year Awarded:	AA-12914-03-50; 2003

Federal Catalog Number:	17.260
Federal Program Title:	WIA Dislocated Workers
Federal Award Number and Calendar Year Awarded:	AA-12914-30-50; 2003

U.S. DEPARTMENT OF TRANSPORTATION

Reference Number:	2004-9-2
Federal Catalog Number:	20.205
Federal Program Title:	Highway Planning and Construction
Federal Award Number and Calendar Year Awarded:	N4520.172; 2004
Category of Finding:	Suspension and Debarment
State Administering Department:	Department of Transportation

CRITERIA

Our review of the Highway Planning and Construction program identified the following compliance requirement:

The Code of Federal Regulations, Title 49, Section 18.35, requires that the State neither make an award nor permit a subgrantee to make an award to any party that is debarred or suspended. Further, Title 49, Section 29.510, states that each participant must submit a certification regarding suspension and debarment at the time the participant submits its proposal.

CONDITION

Although the California Department of Transportation (Caltrans) required its private contractors to submit suspension and debarment certifications, it did not require its subrecipients (local governments) to submit such certifications. We found that Caltrans did not have the appropriate certifications for 20 subrecipients we tested. When Caltrans does not obtain the required certifications, it risks unknowingly allowing suspended or debarred parties to participate in the federal program. For the 20 subrecipients that did not have certifications, we used an alternative test to determine that the subrecipients had not been suspended or debarred.

RECOMMENDATION

Caltrans should ensure that subrecipients are not excluded from participating in federal assistance programs before awarding federal funds to subrecipients.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Suspension and debarment certifications are obtained as a step in ensuring that subrecipients are eligible for participation in federal assistance programs. As such, to ensure Federal Highway Administration (FHWA) suspension and debarment certifications are obtained and maintained by Caltrans, the Division of Local Assistance, Office of Project Implementation (OPI) began incorporating a suspension and debarment provision in its program supplement agreements (PSAs) with subrecipients in February 2005 and plans to incorporate the provision into the master agreement by December 31, 2005. By agreeing to the new provision, the subrecipient is certifying that it has not been suspended or debarred from participation in the federal program, and agrees to notify the State in the event a suspension or debarment occurs after execution of the agreement.

Reference Number:	2004-9-3
Federal Catalog Number:	20.505
Federal Program Title:	Federal Transit–Metropolitan Planning Grants
Federal Award Number and Calendar Year Awarded:	CA-81-X003-01; 2003
Category of Finding:	Suspension and Debarment
State Administering Department:	California Department of Transportation

CRITERIA

Our review of the Federal Transit–Metropolitan Planning Grants (planning grants) program identified the following compliance requirement related to suspension and debarment:

The Code of Federal Regulations, Title 49, Section 18.35, requires that the State neither make an award nor permit a subgrantee to make an award to any party that is debarred or suspended from participating in federal assistance programs. Further, Title 49, Section 29.510, requires the State to obtain from participants certifications affirming that they are not suspended, debarred, ineligible, or voluntarily excluded from transactions by any federal agency.

CONDITION

Although the California Department of Transportation (Caltrans) states in its guidance to subrecipients of the planning grants program that subrecipients must submit suspension and debarment certifications, Caltrans did not always have suspension and debarment certifications from its subrecipients. Specifically, of the 20 subrecipients tested, Caltrans did not have appropriate certifications for six. When Caltrans does not obtain the required suspension and debarment certifications, it risks unknowingly allowing suspended and debarred parties to participate in the federal program. For the six subrecipients that did not have certifications, we used an alternative test to determine that the subrecipients had not been suspended or debarred.

In response to a similar finding we reported during our fiscal year 2002–03 audit, Caltrans stated that it would ensure that subrecipients submit the required suspension and debarment certifications before approving their applications. However, because the fiscal year 2003–04 applications were officially closed out at that time, Caltrans said it would implement new procedures for the completion and retention of the suspension and debarment certifications beginning with fiscal year 2004–05.

RECOMMENDATION

Caltrans should ensure that subrecipients submit the required suspension and debarment certification before it approves their participation in the planning grant program.

DEPARTMENT’S VIEW AND CORRECTIVE ACTION PLAN

To ensure that the Federal Transit Administration (FTA) suspension and debarment certifications are submitted and fully completed by Metropolitan Planning Organizations (MPO) and Regional Transportation Planning Agencies (RTPA), the Caltrans Office of Regional and Interagency Planning (ORIP) issued additional guidance to subrecipients in its annual fiscal year 2004–05 Overall Work Plan (OWP) Guidance for MPOs and RTPAs.

Subsequent to the distribution of the guidance materials, the federal regulations were revised (49 CFR Parts 29 and 32). The revised regulations now place the requirement for the certification at the State level and recommend various alternative methods for a State to ensure subrecipients complete debarment and suspension procedures.

ORIP, in consultation with the Division of Mass Transportation (also responsible for FTA funds) and the Caltrans Legal Office, will determine which procedure is most effective and will most likely select a process of developing a State debarment and suspension certification, and a notice of procedures to ensure the intent of federal regulations is met. This process will be completed by June 30, 2005, in preparation for the 2005–06 fiscal year OWP. ORIP will also ensure that the 2004–05 fiscal year certifications are completed appropriately and continue to emphasize the importance of suspension and debarment certifications in its instructions to subrecipients and will ensure all certifications were received and completed correctly.

Caltrans recognizes that it is using two different approaches to address what is essentially the same finding. OPI and ORIP have different funding and program requirements, thereby requiring a different State response. To be operationally efficient, Caltrans will determine if it can modify the two eligibility processes required by FHWA and FTA for the various subrecipients served.

U.S. ELECTION ASSISTANCE COMMISSION

Reference Number:	2004-1-3
Federal Catalog Number:	39.011
Federal Program Title:	Election Reform Payments
Year Awarded:	State fiscal year 2003–04
Category of Finding:	Activities Allowed, Allowable Costs, Procurement and Suspension and Debarment
State Administering Department:	Office of the Secretary of State

CRITERIA

The Help America Vote Act of 2002, sections 101 and 102 (act), authorized the Election Reform Payments program, which we refer to as HAVA. Our review of HAVA identified the following compliance requirements related to activities allowed, allowable costs, procurement, and suspension and debarment:

As codified in the United States Code, Title 42, sections 15301(b) and 15302(a), the act allows HAVA funds to be used for activities such as replacement of punch card or lever voting machines; improving the administration of elections for federal office; educating voters concerning voting procedures, voting rights, and voting technology; training election officials, poll workers, and election volunteers; and improving the accessibility and quantity of polling places, including providing physical access for individuals with disabilities.

The U.S. Office of Management and Budget Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments* (OMB Circular A-87), states that for costs to be allowable and charged to a federally funded program, the costs must be necessary, reasonable, allocable to that program, and authorized or not prohibited under state or local laws or regulations. In addition, OMB Circular A-87, Attachment B, Section 8.h, states that for employees expected to work solely on a single federal award, charges for their salaries and wages will be supported by periodic certifications that the employees worked solely on that one program. However, for employees expected to work on more than one federal award or on one federal and one nonfederal award, a distribution of their salaries and wages will be supported by personnel activity reports or equivalent documentation that reflect an after-the-fact distribution of each employee's actual activity.

The Code of Federal Regulations, Title 41, Section 105-71.136, requires states to follow the same policies and procedures to procure property and services whether nonfederal funds or a federal grant is used to make the procurements. Additionally, grant recipients and subrecipients must maintain a contract administration system that ensures that contractors perform in accordance with the terms, conditions, and specifications of their contracts or purchase orders. Section 105-71.140 requires grantees to monitor grant- and subgrant-supported activities to ensure that applicable federal requirements are being complied with and that performance goals are being achieved.

Grantee monitoring must cover each program, function, or activity. Finally, Section 105-71.135 requires that the State neither make an award nor permit an award (subgrant or contract) to any party that is debarred or suspended from participation in federal programs.

CONDITION

The Office of the Secretary of State (office) overrode and, in many cases, lacked adequate controls to ensure that it appropriately administered HAVA funds designated to improve the administration of federal elections (discretionary funds). These discretionary funds composed $6.9 million (14.8 percent) of the $46.6 million in HAVA funds the office spent as of June 30, 2004. We found that the office lacked support for the personal service costs it charged to HAVA. In addition, its poor oversight of consultants and consultant contracts also resulted in questionable costs. Because of these weaknesses, we question at least $1.1 million of the $6.9 million in discretionary funds the office spent. Moreover, the office used questionable practices to procure goods and services funded with discretionary funds. As a result, the office may have paid more than was necessary for these items.[1] Finally, the office did not obtain required suspension and debarment certifications from vendors with procurement contracts of $100,000 or more that were paid with discretionary funds or from subrecipients who received HAVA funds to replace voting machines.

The office could not provide support for the personal service costs it charged to HAVA. The office neither prepared the required certifications for its employees who worked full-time on HAVA activities nor instructed its employees who worked part-time on HAVA activities to complete monthly time sheets or other personnel activity reports to support the $1,025,695 in personal service costs it charged to HAVA funds in fiscal year 2003–04. Of the 10 employees we reviewed, five charged 100 percent of their salaries and benefits, totaling more than $497,000, to HAVA. However, according to management staff and the employees we interviewed, the office has never prepared certifications for its employees who work full-time on HAVA activities. Without the certifications required by federal regulations, the office cannot ensure that the salaries and benefits it paid with HAVA funds during fiscal year 2003–04 are accurate and allowable.

The five remaining employees we reviewed charged less than 100 percent of their time to HAVA-funded activities. The total amount the office charged to HAVA for these employees during fiscal year 2003–04 was more than $146,000. Although the office required each employee working on HAVA activities to submit, at the end of fiscal year 2003–04, a document estimating the percentage of time that he or she worked on HAVA and non-HAVA activities during the fiscal year, this method is not permitted by federal cost principles. According to four of the five employees, they based the percentages they reported on their best estimates; they could provide no other documentation to support their basis for arriving at those percentages. The other employee kept a personal log of his time. Because the office did not use time sheets in fiscal year 2003–04, it cannot be sure it charged the correct amount of personal service costs to HAVA funds during that fiscal year.

Further, of the five full-time employees we reviewed whose entire salaries the office charged to HAVA in fiscal year 2003–04, two submitted staff activity reports for attending certain events, such as a celebration of Canada Day and a Black Women Lawyers Association annual holiday mixer, among others, that did not appear related to HAVA. Additionally, even though the office charged 100 percent of the salary of one of these employees to HAVA in fiscal year 2003–04, the employee

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[1] In December 2004 we issued a report titled *Office of the Secretary of State: Clear and Appropriate Direction Is Lacking in Its Implementation of the Federal Help America Vote Act,* which more fully discusses the office's administration of HAVA.

indicated that only about 80 percent of her time was spent on HAVA activities. Charging HAVA for staff activities that are not associated with allowed uses of these funds puts the office at risk that the federal government may ask for the repayment of some, if not all, of these funds.

The office's poor oversight of consultants also resulted in the questionable use of HAVA funds. Of the 169 staff activity reports that regional outreach consultants submitted between December 3, 2003, and September 5, 2004, 62 (37 percent) listed one or more activities that had no relationship to any HAVA requirements. For example, some consultants reported attending events—such as fundraisers and a state delegation meeting for the Democratic National Convention—as representatives of the secretary of state. However, HAVA does not specify attendance at fundraisers and political delegation meetings as allowable activities. Moreover, we could not quantify the amounts paid to the consultants for attending these types of events because the office did not require the contractors to indicate on their invoices the activities they were billing for or how much time they spent on each activity. Because the office failed to properly and adequately account for the activities of some consultants hired to assist in the implementation of HAVA, we question the use of federal funds to pay for them.

In another instance of using HAVA funds to pay for non-HAVA activities, the office paid a law firm $1,050 for the preparation of three speeches that had little to do with HAVA. Our review of the written text for two speeches revealed that the speeches clearly had nothing to do with HAVA. One was given at a Unity in Diversity dinner organized by the Indo-American Community Federation, and the other speech was in commemoration of Indian Republic Day. Although the third speech referred to certain requirements of HAVA, more than half of the speech presented statistics concerning the October 2003 recall election of California's governor, bringing into question whether the entire speech should have been paid for with HAVA funds.

Further, the office's poor contract oversight resulted in its paying almost $70,000 for invoiced services that violated the terms of one contract and almost $5,000 on a second contract for a work product it may not have received. Specifically, the provisions of the original contract with a law firm stipulated that the firm's daily charge for services would not exceed $1,200 per day and that the firm would provide services one day a week on an as-needed basis. However, the invoice the law firm submitted in April 2004 covering services rendered from November 17, 2003, through April 7, 2004, lists 17 separate days on which the amount the law firm charged the office exceeded the contract's $1,200-per-day limit. Moreover, rather than providing services one day a week as called for by the terms of the contract, the firm billed the office for 22 days in January, 21 days in February, 23 days in March, and five days in the first two weeks of April 2004. Finally, although the term of the contract was from December 1, 2003, through December 31, 2004, the office paid for services rendered in November 2003—before a binding contract was in place.

In the second example of poor contract oversight, the office hired a consulting firm to perform public outreach within the context of HAVA. The consultant proposed preparing an outreach plan and was asked to identify specific events, people, and opportunities for outreach. Although the office used HAVA funds to pay this consultant $4,750, it was unable to provide us with a plan or any other work products for this contract.

In addition to its poor oversight of staff and consultants, the office used questionable practices to procure goods and services paid for with discretionary funds. Specifically, the office used an exemption from competitive bidding it had requested and received from the Department of General Services (General Services) for 46 of the 77 HAVA contracts it entered into between June 2003 and September 2004; the 46 contracts totaled more than $1.5 million. The justification the office provided General Services for this exemption was the urgent need to meet deadlines set forth in HAVA. However, most of the contracts entered into under the no-bid exemption were for services that did not relate to any specific HAVA deadline and could have been competitively bid had the office planned better. For example, most of the activities performed by these consultants were for regularly scheduled elections occurring in March and November 2004. In addition, the office could not provide us with documentation, such as plans, showing what activities these consultants were to complete by March 2004 or by any other specified deadline. The office also did not establish a way to determine whether the consultants' efforts were successful. Because the office used the no-bid exemption rather than competitively bidding, the State has less assurance that it received the best value for its HAVA expenditures.

Further, the office did not follow best practices in making California Multiple Award Schedule (CMAS) procurements. CMAS is a procurement method that allows state agencies to avoid the administrative time and expense of the State's formal competitive bid process by purchasing goods and services under preestablished contracts awarded and maintained by General Services. However, the office did not follow its policy and obtain competitive offers for most of its CMAS procurements. In addition, rather than obtain competitive bids and use one contract, the office used multiple CMAS contracts to procure information technology (IT) consulting services totaling $631,000 from one vendor and $1,145,000 from another. In January 2003 General Services set the CMAS order limit at $500,000 on all IT purchases and stipulates that if the total of multiple purchase orders exceeds that limit, state agencies should document why the orders are separate. Nevertheless, we found no documentation in which the office explained why these CMAS purchase orders for IT consulting services were separate and not combined.

Additionally, despite its policy to follow the same practices General Services requires of other state agencies, the office did not obtain comparison quotes for 10 of the 12 HAVA-expensed purchase orders it made using CMAS. General Services requires state agencies to solicit three price quotations for CMAS purchases exceeding $5,000. The 10 purchases the office made for HAVA totaled $1.9 million.

Moreover, for two of three commodity purchases we reviewed, the office failed to follow the state procurement policy requiring agencies to obtain at least two informal bids for commodity purchases exceeding $5,000; the two purchases totaled $23,000. As a result of these practices, the State is less sure that the office obtained the best value for the purchases it made with HAVA funds.

Finally, the office did not obtain suspension and debarment certifications from the five subrecipients we tested who received HAVA funds for voting machine replacement or from the two vendors who received more than $100,000 of discretionary funds in fiscal year 2003–04. The office also did not verify whether any of these subrecipients were suspended or debarred. However, we used an alternative test to determine that none of the subrecipients or vendors we reviewed were suspended or debarred.

RECOMMENDATIONS

To establish or strengthen controls, comply with federal and state laws, and reduce the risk that HAVA funds are spent inappropriately, the office should take the following actions:

- Ensure that time charged to HAVA or any other federal program is supported with appropriate documentation, including time sheets and certifications.

- Follow control procedures for the review and approval of contracts to ensure that contracts include a detailed description of the scope of work, specific deliverables, and performance measures.

- Require that contract managers monitor for the completion of contract services and work products prior to approving invoices for payment.

- Review invoices to ensure that charges to be paid with HAVA funds are reasonable and allowable and conform to the terms of the contract.

- Follow competitive bidding requirements to award contracts and restrict the use of exemptions to those occasions that truly justify the need for them.

- Follow General Services' policies when using CMAS for contracting needs.

- Comply with state policy for procuring commodities.

Finally, the office should develop a process to ensure its subrecipients and applicable vendors are not suspended or debarred from doing business with the federal government.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Thank you for the opportunity to respond to the preliminary audit report regarding the implementation by the Office of the Secretary of State of the Election Reform Program. Specifically, the report focuses on the Help America Vote Act of 2002 (HAVA), Sections 101 and 102, with an emphasis on Section 101, the discretionary funds provided to the Office of the Secretary of State to educate voters, improve the administration of federal elections, and for specified purposes.

We appreciate the Bureau of State Audit's (Bureau) report and recommendations and discuss below our intentions to implement as soon as possible the recommendations not already implemented.

As the Bureau correctly indicated in its report issued December 2004 with respect to a parallel state audit, this office was overburdened by a cyclone of unprecedented and historic forces:

- a combination of three elections—a first-ever statewide recall election, a presidential primary, and a presidential general election;

- a nation-wide controversy over electronic voting that threatened to undermine public confidence in the equipment used to cast and count ballots; and

- the management of HAVA, a complex law with built-in ambiguities and little administrative guidance.

This office historically has not administered federally funded programs. Even with conflicting demands on our time and staff, we have been able to competently fulfill our core mission of supervising those elections during this period. In particular, this office and county elections officials received high marks for the efficient and professional manner in which the unprecedented recall election was conducted.

So while we are disappointed that our administration of HAVA may not have been consistent with our performance in other areas, any mistakes that were made were certainly not intentional. We don't believe the audit report finds otherwise.

We continue to believe that the *sum total* of work performed—whether directed at increasing voting access for the disabled community, ensuring the accuracy and security of electronic voting machines, or providing voter education—can be fairly characterized as professional, solid work that the Secretary of State's office performed in the public interest.

We are now in the process of implementing all of your recommendations, in addition to the changes we have made at our own initiative over the past several months to ensure proper management and oversight of HAVA activities.

We have recently appointed a new upper-level management team. Each member of that team has extensive experience with state systems and procedures and the ability to administer effectively the office and its programs, particularly the HAVA program.

In addition, in December 2004, we contracted with a respected management consulting firm (MGT of America, Inc.) to provide oversight of HAVA implementation activities. We are confident our new team, working in collaboration with the HAVA management contractor and newly appointed HAVA Coordinator, will improve the program's effectiveness and productivity.

We have also adopted several *HAVA Implementation Guiding Principles* that govern our administration of HAVA, which are being distributed to all persons in the agency involved with the administration of HAVA. These persons are being requested to indicate in writing that they have read and understand the principles. These *Guiding Principles* are:

1. **Every dollar of HAVA funds received shall be spent and accounted for in accordance with all applicable federal and state laws, regulations and procedures.**

2. **No HAVA funds shall ever be used to promote any political party, candidate for elective office, ballot measure, political cause or political interest group.**

3. **All grants and contracts using HAVA funds shall be made only to further the implementation of HAVA and shall be allocated objectively and equitably to eligible participants only.**

4. **All HAVA mandates will be met by the statutory deadlines, to the extent control agency approvals permit.**

5. **The Secretary of State's Office shall, in consultation with local elections officials and other interested parties, including the Department of Finance and the Legislature, including the Joint Legislative Budget Committee and the Joint Legislative Audit Committee, determine the most effective and efficient way of achieving the goals of HAVA and ensuring compliance with HAVA mandates.**

6. **The Secretary of State's Office shall, in consultation with local elections officials and other interested parties, monitor California's progress toward reaching the goals and mandates of HAVA.**

7. **The activities needed to achieve the goals and mandates of HAVA shall be planned, implemented, and monitored using sound project management principles.**

8. **All contracts using HAVA funds shall be awarded using a competitive procurement process whenever possible.**

9. **The Secretary of State's Office, in consultation with local elections officials, the Election**

Assistance Commission, and other interested parties, shall develop performance measures to determine the effectiveness of all programs and efforts that receive HAVA funds.

10. **The Secretary of State shall monitor the use of HAVA funds by any entity that receives them to ensure compliance with the requirements of the grant or contract and with HAVA.**

With this preliminary audit report in hand and the Bureau's parallel state report in hand, we will now take even more aggressive corrective action, including the implementation of all the audit's recommendations, as follows:

(1) Bureau Recommendation: Ensure that time charged to HAVA or any other federal program is supported with appropriate documentation, including time sheets and certifications.

- We have developed time sheets and procedures that comply fully with federal guidelines.

(2) Bureau Recommendation: Follow control procedures for the review and approval of contracts to ensure that contracts include a detailed description of the scope of work, specific deliverables, and performance measures.

- We have established a more efficient contract review process, which requires any contractor to have a detailed scope of work, specific deliverables, and performance measures. These requirements are now standard practice at the Office of the Secretary of State.

(3) Bureau Recommendation: Require that contract managers monitor for the completion of contract services and work products prior to approving invoices for payment.

- The office has reminded its managers of the need to ensure the completion of contract deliverables prior to approving invoices for payment and is writing detailed procedures for invoice approval.

(4) Bureau Recommendation: Review invoices to assure that charges to be paid with HAVA funds are reasonable and allowable and conform to the terms of the contract.

- We have implemented a system whereby a manager from our Management Services Division reviews contractors' deliverables and matches them against the contractors' contracts. If obligations are not met, no HAVA funds will be disbursed. The new management consultant will have a role in this oversight as well.

(5) Bureau Recommendation: Follow competitive bidding requirements to award contracts and restrict the use of exemptions to those occasions that truly justify the need for them.

- We will restrict the use of exemptions from competitive bidding to those occasions that truly justify the need.

(6) Bureau Recommendation: Follow General Services' policies when using CMAS for contracting needs.

- We will comply fully with applicable state procurement policies.

(7) Bureau Recommendation: Comply with state policy for procuring commodities.

- We will comply fully with applicable state procurement policies.

(8) Bureau Recommendation: Ensure that subrecipients and vendors it awards HAVA funds to are not suspended or debarred from doing business with the federal government.

- We will ensure that all subrecipients and vendors receiving HAVA funds are not suspended or debarred from doing business with the federal government.

It should be noted that the Office of the Secretary of State has been working on the planning and implementation of HAVA for nearly 24 months. In that time, we have made significant progress in implementing this complex law, including:

- The Secretary of State, in consultation with county elections officials, has allocated and distributed $51.1 million to counties for replacement of punch-card voting machines. This is in addition to the approximately $59 million that counties have already received for voting machine modernization as a result of the passage of Proposition 41. The Secretary of State has also allocated $9.9 million to counties for voter education and poll worker training and $4.6 million to counties to enhance the security of electronic voting machines.

- The office, in consultation with county elections officials, has developed a Provisional Ballot and Free Access Program, which provides all California voters with the right to cast provisional ballots and a method to determine whether the ballots were counted.

- The office has established an information clearinghouse for military and overseas voters.

- We revised voter registration forms to be consistent with HAVA requirements and these forms have been distributed to 58 California counties.

- The office has developed and implemented the nation's first "parallel monitoring" program to help ensure accuracy and security of electronic voting machines.

- Working with the county elections officials, we have successfully developed and implemented a posting program to inform voters of their rights.

- The office has developed a program for implementing HAVA's identification requirements for certain first-time voters who register to vote by mail. The office developed and implemented an interim system to verify information regarding voters who would otherwise have to present identification in order to vote.

- The office has developed and implemented an administrative complaint procedure.

With respect to implementing HAVA, much has been accomplished, but much remains to be done in order to meet various January 1, 2006, deadlines. We are committed to working with county elections officials, the Election Assistance Commission, the Governor, the Legislature, and other organizations and individuals to make California's implementation of HAVA a model for the nation.

We look forward to continuing the positive working relationship with the Bureau that has been established through this audit effort. We invite the Bureau to work closely with us as we strive to complete an exemplary HAVA program.

U.S. DEPARTMENT OF EDUCATION

Reference Number:	2004-3-1
Federal Catalog Number:	84.357
Federal Program Title:	Reading First State Grants
Federal Award Numbers and Calendar Years Awarded:	S357A020005; 2002 S357A030005; 2003
Category of Finding:	Cash Management
State Administering Department:	Department of Education

CRITERIA

Our review of the Reading First State Grants program (Reading First) identified the following requirements related to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows a state's subrecipients to receive advance payments provided they demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Further, this section requires a state's subrecipients to promptly pay the federal agency any interest greater than $100 per year that they earned on advances. Additionally, if a state's subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures to minimize the time between receipt and disbursement of federal funds.

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that Reading First subrecipients demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Under its payment procedures, Education disburses predetermined percentages of program funds to subrecipients rather than assessing and disbursing funds based on each subrecipient's immediate cash needs. Further, Education does not always require its subrecipients to report their use of program advances before it makes additional payments to them. As a result, Education does not ensure that subrecipients minimize the time between receipt and disbursement of federal funds.

Of the 29 subrecipients we reviewed for Reading First, Education made advance payments to 26 subrecipients during fiscal year 2003-04. Because Education disbursed approximately 50 percent of the program funds awarded to these subrecipients before it received expenditure reports, it disbursed more than $51 million with no assurance that these subrecipients had minimized the time between receipt and disbursement of federal funds.

Additionally, 11 of these subrecipients reported in their midyear expenditure reports that they had spent less than 75 percent of the previous two advances. Although we believe it is reasonable to expect that Education would have adjusted the third payment down to reflect the actual midyear expenditures, it instead disbursed to these 11 subrecipients the full amount of the third payment totaling more than $3.5 million. One of the 11 subrecipients reported it had not spent any of its advance payments totaling more than $1 million, yet Education provided this subrecipient with a third advance of more than $500,000. As a result, Education awarded funds to subrecipients with no assurance that subrecipients minimized the time between receipt and disbursement of federal funds.

Further, Education did not require subrecipients of its 2002–03 and 2003–04 grant awards to report and remit interest in excess of $100 earned on federal program advances. As a result, the subrecipients may have used the interest earned on federal program advances for activities that are not allowed.

RECOMMENDATIONS

To minimize the time between subrecipients' receipt and disbursement of federal funds, Education should implement procedures to assess each subrecipient's cash needs and, if necessary, adjust its advance payments to more closely reflect each of its subrecipients' immediate cash needs. If Education cannot demonstrate its ability to ensure that subrecipients minimize the time between receipt and disbursement of federal funds, it should implement procedures to pay its subrecipients on a reimbursement basis rather than paying them in advance. Finally, Education should also establish controls for reporting interest earnings greater than $100 on these advances so it can ensure that these interest earnings are repaid to the federal awarding agency.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

For future payments, Education will evaluate cash needs of subrecipients from interim expenditure reports and adjust advance payments as needed. The fiscal year 2004–05 subrecipient grant award letters include instructions for reporting any interest payments over $100.

Reference Number:	2004-3-2
Federal Catalog Number:	84.002
Federal Program Title:	Adult Education—State Grant Program
Federal Award Numbers and Calendar Years Awarded:	V002A020005; 2002 V002A030005; 2003
Category of Finding:	Cash Management
State Administering Department:	Department of Education

CRITERIA

Our review of the Adult Education—State Grant Program (Adult Education program) identified the following requirements related to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows a state's subrecipients to receive advance payments provided they demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Further, this section requires a state's subrecipients to promptly pay the federal agency any interest greater than $100 per year that they earned on the advances. Additionally, if a state's subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between receipt and disbursement of federal funds.

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that program subrecipients demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Under its payment procedures, Education disburses predetermined percentages of program funds to subrecipients rather than assessing and disbursing funds based on each subrecipient's immediate cash needs. During the fiscal year, Education typically disburses funds to subrecipients through two payments of 33 percent of the subgrant award for the English Literacy and Civics Education components of the Adult Education program. In addition, Education disburses funds to subrecipients for sections 225 and 231 of the Adult Education program through two payments of 50 percent and 25 percent, respectively, of the subgrant award. After it receives the subrecipients' final expenditure report, Education disburses the final payment. Although the timing of the disbursements appears reasonable, Education does not require subrecipients to report their expenditures before disbursing the second payment. Thus, it has little assurance that subrecipients minimize the time between receipt and disbursement of federal funds.

Of the 40 payments to subrecipients we reviewed for the Adult Education program, 23 involved disbursements made before Education received information on the subrecipients' use of funds; Education disbursed more than $1.1 million to its subrecipients with inadequate assurance that the subrecipients had minimized the time between receipt and disbursement of federal funds. Finally, Education did not require subrecipients to report and remit interest exceeding $100 per year that they earned on the federal program advances. As a result, these subrecipients could have used the interest earned on advances for activities that are not allowed.

RECOMMENDATIONS

To minimize the time between subrecipients' receipt and disbursement of federal funds, Education should implement procedures to assess each subrecipient's cash needs and adjust its advance payments accordingly. Additionally, Education should ensure that its subrecipients report their program expenditures in time to allow Education to assess their cash needs before it makes additional advance payments. If Education determines it cannot implement procedures to ensure that its subrecipients report their program expenditures in time to allow Education to assess their cash needs before it makes additional payments, it should implement procedures to pay its subrecipients on a reimbursement basis rather than in advance. Finally, Education should also establish controls to ensure that its subrecipients report interest greater than $100 that they earned on the advances and repay that income to the federal awarding agency.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

For the 2004–05 fiscal year, Education amended its payment method to subrecipients in order to minimize the time elapsing between the receipt and use of federal program funds. Subrecipients initially receive 50 percent of their preliminary grant award amount, and then are required to submit a mid-year report showing expenditures and encumbrances toward their grant award amount. If the subrecipient expended or encumbered at least 80 percent of the initial payment, Education processes a second payment of 25 percent of the grant award amount. If the subrecipient expended or encumbered less than 80 percent of the initial payment, Education processes a second payment of only 12.5 percent of the grant award amount. Education continues to require a final report showing total grant expenditures and encumbrances.

In addition, the subrecipients are required to indicate on the mid-year and final reports the amount of interest earned on advance payments, and to promptly remit interest greater than $100 to the federal agency.

Reference Number:	2004-3-3
Federal Catalog Number:	84.010
Federal Program Title:	Title I Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A030005A; 2003
Category of Finding:	Cash Management
State Administering Department:	Department of Education

CRITERIA

Our review of the Title I Grants to Local Educational Agencies program (Title I, Part A) identified the following requirements relating to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows a state's subrecipients to receive advance payments provided they demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Further, this section requires a state's subrecipient's to promptly pay the federal agency any interest greater than $100 that they have earned on the advance. Additionally, if a state's subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between receipt and disbursement of federal funds. Moreover, grant requirements state that the regulations in Section 80 apply to Title I of the Elementary and Secondary Education Act of 1965, as amended.

In addition, the United States Code, Title 20, Section 6312(a)(1), indicates that a local educational agency (LEA) may receive subgrants under this section for any fiscal year only if it has filed with the Department of Education (Education) a plan approved by the State Board of Education (state board).

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that Title I, Part A subrecipients, which are all LEAs, demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Under its payment procedures, Education disburses predetermined percentages of program funds to subrecipients rather than assessing and disbursing funds based on each subrecipient's immediate cash needs. Further, Education does not require its subrecipients to report their use of program advances before it makes additional payments to them. Education's lack of procedures to assess each subrecipient's cash needs, combined with its predetermined advance-payment process, does not adequately ensure that subrecipients minimize the time between receipt and disbursement of federal program funds.

Of the 39 expenditure transactions we reviewed for Title I, Part A funds, Education disbursed approximately 80 percent of the funds during fiscal year 2003–04 without receiving information on the subrecipients' use of funds. As a result, Education disbursed more than $319 million with limited assurance that subrecipients minimized the time between receipt and disbursement of federal funds.

We also found that Education does not ensure that the state board has approved subrecipients' plans prior to subrecipients receiving Title I, Part A funds. Subrecipients submit a five-year plan as a requirement for receiving federal funding for No Child Left Behind programs. The plan includes specific descriptions and assurances and describes the actions that subrecipients will take to ensure that they meet certain requirements. Title I, Part A funds are disbursed in three apportionments. We considered an approval appropriate when the state board had approved the plan prior to the disbursement of federal funds.

For fiscal year 2003–04, the state board did not approve five of 40 plans we reviewed prior to the disbursement of federal funds. Education disbursed $583,166 to the five subrecipients.

RECOMMENDATIONS

To ensure that subrecipients minimize the time between receipt and disbursement of federal funds, Education should implement procedures to assess each subrecipient's cash needs and, if necessary, adjust its advance payments to more closely reflect those needs. Additionally, Education should ensure that its subrecipients report their program expenditures in time to allow Education to assess their cash needs before making additional advance payments. Moreover, if Education cannot demonstrate its ability to ensure that subrecipients minimize the time between receipt and disbursement of federal funds, it should implement procedures to pay its subrecipients on a reimbursement basis rather than paying them in advance. Finally, Education should ensure that subrecipients of Title I, Part A funds have a state board-approved plan on file prior to the disbursement of federal funds.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

With limited resources available to monitor whether subrecipients' advance payments are expended before subsequent payments are issued, Education is exploring various options for an optimal approach on monitoring, which includes seeking guidance from the United States Department of Education on its expectations.

In the interim, Education continues to allocate funds proportionate to the unpaid months that have elapsed prior to and including the month of the current apportionment, based on the principle that LEAs incur federal expenditures fairly constantly through the year. During the 2003–04 fiscal year, Education included language in apportionment letters to notify LEAs of a potential delay in funding if significant carry over balances existed. The next step will be separate written notifications to non-compliant LEAs that will detail specific dollar amounts and percentages. Currently, our plan is to issue these notifications at the release of the second 40 percent payment.

Furthermore, the Title I program office monitors the percentage of carry over balances as submitted on Part I of the Consolidated Application. When an LEA is over their 15 percent carry over limit, a waiver is requested from the program office. Program staff reviews/approves and notifies fiscal staff if funds should be withheld.

Education refined its process in fiscal year 2004–05 to ensure all LEA plans are approved by the State Board prior to the disbursement of federal funds. A file of the Consolidated Application (ConAp) Title I participants is compared to a listing of active schools to ensure those applying to participate in Title I funds are operating. When a LEA plan is received, it is reviewed to ensure all the information is present, then it is forwarded to the State Board for approval. The calcuations of the entitlement are completed, but no funds are released into the apportionment until a State Board approved LEA plan is in Education's file and is verified against the ConAp and active schools listing. Education also checks the file as apportionments are ready for release to ensure there is a State Board approved LEA plan.

Reference Number:	2004-3-4
Federal Catalog Number:	84.243
Federal Program Title:	Tech-Prep Education
Federal Award Number and Calendar Year Awarded:	V243A030005; 2003
Category of Finding:	Cash Management
State Administering Department:	California Community Colleges, Chancellor's Office

CRITERIA

Our review of Tech-Prep Education program (Tech-Prep) identified the following requirements related to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows a state's subrecipients to receive advance payments provided they demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Additionally, if a state's subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between receipt and disbursement of federal funds.

CONDITION

The California Community Colleges, Chancellor's Office (Chancellor's Office), does not have adequate procedures to ensure that Tech-Prep subrecipients minimize the time between receipt and disbursement of federal funds. Under its payment procedures the Chancellor's Office approves Tech-Prep advances for each subrecipient and disburses the advances each month based on predetermined percentages. However, because the Chancellor's Office approved advances that exceeded some subrecipients' immediate cash needs, some subrecipients carried excessive cash balances during the fiscal year.

The Chancellor's Office approves subrecipient applications, calculates advances, and pays the advances in monthly installments. To determine if a subrecipient's spending approximates the advances, the Chancellor's Office uses the subrecipient's quarterly year-to-date expenditure reports to compare the reported expenditures to the amounts it advanced the subrecipient. If it determines that the subrecipient's spending approximates the advances, it is the policy of the Chancellor's Office to authorize further advance payments in full; otherwise, its policy is to reduce the subrecipient's monthly advance payments. Further, when the Chancellor's Office determines that a reduction in the monthly advance payment amount is warranted, it generally begins making adjustments in the third quarter of the fiscal year.

Our review found that a significant number of subrecipients of Tech-Prep that we reviewed maintained high cash balances during the first and second quarters of fiscal year 2003–04. Because Tech-Prep subgrants are small, we considered balances high when they exceeded 10 percent of the amounts advanced by the Chancellor's Office and were at least $7,000. We found that 10 of the 20 subrecipients we reviewed maintained high cash balances ranging from $7,975 to $26,250 during the first quarter. Additionally, during the second quarter, eight of 20 subrecipients maintained high cash balances ranging from $7,454 to $36,829.

The Chancellor's Office is responsible for ensuring that subrecipients minimize the time between receipt and disbursement of federal funds. However, when the Chancellor's Office does not adequately assess its subrecipients' immediate cash needs before approving advances, it cannot ensure that subrecipients minimize the time between receipt and disbursement of federal funds.

RECOMMENDATIONS

To minimize the time between subrecipients' receipt and disbursement of federal funds, the Chancellor's Office should reassess the amount disbursed through the advance process and approve initial advances that more closely reflect each subrecipient's immediate cash needs. If the Chancellor's Office cannot demonstrate its ability to ensure that subrecipients minimize the time between receipt and disbursement of federal funds, it should implement procedures to pay its subrecipients on a reimbursement basis rather than paying them in advance.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The Chancellor's Office continues to "fine-tune" its system of putting funding into the apportionment process for the 72 community college districts, and adjusts advances based on prior expenditure patterns. Additionally, because expenditure reports are now submitted electronically, the Chancellor's Office easily can monitor the aggregate expenditures of the community college system.

Complicating factors for easy resolution of this continuing issue include the following:

- The federal Act limits reimbursable administrative expenditures by both the Chancellor's Office and the local sub-recipients, and a cost-reimbursement system of cash management (invoicing and processing disbursements)—given the scope of California—would have its own problems. The response time for such a system would interfere with the timely implementation of the program's objectives. Additionally, the added expense of such a system's operation would divert funds from the programs and colleges objectives. To serve the program's purposes best, the Chancellor's Office is attempting to use the most cost-effective system for cash disbursement.

- The apportionment process used offers only limited occasions (one prior to the fiscal year, two during the fiscal year, and one after the fiscal year) to adjust the flow of cash, and those occasions are not fully in sync with the regular quarterly reporting process. Additionally, the apportionment process has fixed percentages of funds that are released month by month, and those percentages are set in State Statue.

- Because of varying local conditions, prior patterns of expenditure are not an exact predicator of future patterns of expenditure.

The Chancellor's Office is concerned that the sub-recipient monitoring and cash management citing incompletely describes the cash management situation, and hopes that in the future a more complete analysis will be provided in any citings.

The material question of whether—or the extent to—the Chancellor's Office in its administration of Perkins funds created a condition of excess cash in "draw downs" from the U.S. Dept. of Education is not answered because of an incomplete analysis of sub-recipient monitoring.

The audit analysis instead builds the citing on an intermediate step in a much larger process of cash management. Specifically, the analysis notes several individual recipients who report expenditures less than cash received to date. Critically, though, the analysis fails to include those situations where individual recipients have expenditures greater than cash received to date. The community college system, which receives down cash in aggregate, experiences internal account balancing where—in fact—over-expenditures can offset under-expenditures, and the question of whether the State of California has drawn down excessive cash can only be answered after a more complete analysis.

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

We acknowledge that it is difficult to balance the needs of subrecipients with the requirements for advancing federal funds to them. However, if the Chancellor's Office is unable to comply with these requirements, it should consider paying its subrecipients on a reimbursement basis or seeking a waiver from the U.S. Department of Education from these requirements. Despite the concerns raised by the Chancellor's Office, the requirements we test and the procedures we perform are those included in the U.S. Office of Management and Budget Circular A-133 compliance supplement. Accordingly, we cite the laws and regulations relevant to them.

Reference Number:	2004-3-5
Category of Finding:	Cash Management
State Administering Department:	Department of Education

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of the Special Education—Grants to States program and the Special Education—Preschool Grants program identified the following requirements relating to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows subrecipients to receive advance payments provided they demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Additionally, if subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between receipt and disbursement of federal funds.

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that program subrecipients demonstrate the ability to minimize the time between receipt and use of federal funds. Although Education obtains information that would allow it to assess each subrecipient's cash needs and disburse funds accordingly, it does not do so. Instead, under its payment procedures, Education disburses predetermined percentages of program funds to subrecipients during the grant period and then disburses any remaining amounts owed after it recieves the subrecipient's final expenditure reports, which are due 60 days after the end of the grant period. For fiscal year 2003–04 Education also required subrecipients to submit a midyear report of expenditures as of February 15, 2004; however, it did not use these reports to adjust the subrecipients' subsequent payments, missing an opportunity to ensure that the payments more closely aligned with subrecipients' actual cash needs.

For the subrecipients of the Special Education—Grants to States program for the grant period July 2003 through September 2004, our review found that Education generally disbursed 50 percent of subrecipients' initial grant awards in February 2004 and an additional 25 percent in May 2004. In addition, to two subrecipients of the Special Education—Preschool Grants program that we reviewed, Education disbursed 50 percent of the subrecipients' initial grant awards in March 2004 and an additional 25 percent in May 2004. Although the timing and the amounts of the disbursements suggest that Education's process is adequate to ensure that subrecipients do not receive federal funds significantly before they are needed, our review of 32 subrecipients' midyear reports of expenditures indicates that this was not always the case.

When we compared Education's first payments to 32 subrecipients with their midyear expenditure reports, Education appeared to have disbursed appropriate amounts to 14 subrecipients. However, our comparison showed that Education's first payments to another 18 subrecipients significantly exceeded the expenditures of those subrecipients. We considered the difference significant when payments exceeded expenditures by at least 15 percent. For example, Education disbursed $6.3 million as the first payment to one subrecipient that reported expenditures of only $412,000 in its midyear report. Although we would have expected Education to adjust the second payment downward to reflect the subrecipient's actual midyear expenditures, it instead disbursed to this subrecipient the full amount of its second payment totaling $3.1 million. Finally, although four other subrecipients did not submit midyear reports, Education still provided them with the full amounts of their second payments totaling $2.8 million.

RECOMMENDATIONS

To minimize the elapsed time between subrecipients' receipt and disbursement of federal funds, Education should use the expenditure information reported in the midyear reports to allow it to assess subrecipients' cash needs before making additional advance payments. If Education determines it cannot use subrecipients' reported program expenditures to assess their cash needs and make additional payments, it should consider procedures to pay its subrecipients on a reimbursement basis rather than paying them in advance.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education implemented the midyear report for the first time in fiscal year 2003–04, and is enhancing it for fiscal year 2004–05 with stricter language to ensure assessment of each subrecipient's cash needs. This procedure will allow Education to adjust payments in accordance with the federal government "Cash Management" requirements outlined in Title 34, Code of Federal Regulations, section 80.21.

U.S. DEPARTMENT OF EDUCATION

Federal Catalog Number:	84.027
Federal Program Title:	Special Education—Grants to States
Federal Award Numbers and Calendar Years Awarded:	H027A020116; 2002 H027A030116; 2003

Federal Catalog Number:	84.173
Federal Program Title:	Special Education—Preschool Grants
Federal Award Numbers and Calendar Years Awarded:	H173A020120; 2002 H173A030120; 2003

Reference Number:	2004-3-6
Federal Catalog Number:	84.318
Federal Program Title:	Education Technology State Grants
Federal Award Numbers and Calendar Years Awarded:	S318X020005A; 2002 S318X030005; 2003
Category of Finding:	Cash Management
State Administering Department:	Department of Education

CRITERIA

Our review of the Education Technology State Grants program (Education Technology) identified the following requirements relating to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows a state's subrecipients to receive advance payments provided they demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Additionally, if a state's subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between receipt and disbursement of federal funds.

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that Education Technology subrecipients demonstrate the ability to minimize the time between receipt and disbursement of federal program funds. Under its payment procedures Education disburses predetermined percentages of program funds to subrecipients rather than assessing and disbursing funds based on each subrecipient's immediate cash needs. Further, Education does not always require its subrecipients to report their use of program advances before it makes additional payments to them. As a result, Education does not ensure that subrecipients minimize the time between receipt and disbursement of federal funds.

Education awards Education Technology funds to subrecipients in two ways: as a formula grant and as a competitive grant. Of the 35 payments to subrecipients made during fiscal year 2003–04 that we reviewed for Education Technology, we identified cash management weaknesses in both types of awards.

For nine formula grant subrecipients we reviewed, Education disbursed 85 percent of their 2002 awards between August and November 2003. However, Education did not require these subrecipients to report their expenditures until October 2004, at least 11 months after disbursing the payments. As a result, Education disbursed $505,000 with no assurance that subrecipients had minimized the time between receipt and use of federal funds. Further, although Education's policy requires each subrecipient to submit a final expenditure report before it can receive the final payment, Education disbursed final payments totaling $6,400 to three of the nine subrecipients before receiving final expenditure report information on the subrecipients' use of funds.

Finally, for 16 competitive grant subrecipients, Education disbursed 90 percent of the 2002 awards in two equal payments of 45 percent. Education generally made the disbursements in September 2003 and March 2004. However, Education did not require these subrecipients to report any expenditure information before disbursing the second payment. As a result, Education disbursed $4.2 million with no assurance that the subrecipients had minimized the time between receipt and disbursement of federal funds.

RECOMMENDATIONS

To minimize the time between subrecipients' receipt and disbursement of federal program funds, Education should implement procedures to assess each subrecipient's cash needs and, if necessary, adjust advance payments to more closely reflect each subrecipient's immediate cash needs. Additionally, Education should ensure that its subrecipients report their program expenditures in time to allow Education to assess their cash needs before making additional advance payments. Finally, if Education cannot ensure that subrecipients minimize the time between receipt and disbursement of federal funds, it should implement procedures to pay its subrecipients on a reimbursement basis rather than paying them in advance.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The Enhancing Education Through Technology (Education Technology) formula grant provides subrecipients advance payments to implement their approved technology plan, which may require significant purchases of hardware and software. To facilitate the subrecipients' ability to make the required Education Technology program purchases and take advantage of discounts, Education provides the subrecipients advance payments.

With almost 1,000 potential Education Technology subrecipients, and over 500 grant awards under $10,000, Education is exploring various methods for an optimal monitoring approach, including seeking guidance from the United States Department of Education to meet federal monitoring expectations with Education's limited resources.

Education continues to monitor end of period expenditure reports, which provides signed assurances that funds were expended in accordance with the grant award documents. Education bills subrecipients for:

1. unspent amounts reported on the end of period expenditure reports; and

2. total grant award amounts if the end of period expenditure report is not submitted to Education.

Education has recently sent final warning letters related to 2) described above and is prepared to send bills if the reports are not received by January 31, 2005.

Reference Number:	2004-3-7
Federal Catalog Number:	84.367
Federal Program Title:	Improving Teacher Quality State Grants
Federal Award Number and Calendar Year Awarded:	S367A030005A; 2003
Category of Finding:	Cash Management
State Administering Department:	Department of Education

CRITERIA

Our review of the Improving Teacher Quality State Grants (Improving Teacher Quality) program identified the following requirements related to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows a state's subrecipients to receive advance payments provided they demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Additionally, if a state's subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between receipt and disbursement of federal funds.

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that subrecipients of the Improving Teacher Quality program demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Under its payment procedures, Education disburses predetermined percentages of program funds to subrecipients rather than assessing and disbursing funds based on each subrecipient's immediate cash needs. Further, Education does not always require its subrecipients to report their use of program advances before it makes additional payments to them. As a result, Education does not ensure that subrecipients minimize the time between receipt and disbursement of federal funds.

Of the 39 subrecipients we reviewed for the Improving Teacher Quality program, Education disbursed 100 percent of the funds without receiving information on the subrecipients' use of funds. As a result, Education disbursed more than $12.1 million with no assurance that these subrecipients minimized the time between the receipt and disbursement of federal funds.

We reported a similar issue in our fiscal year 2002–03 audit report, and as of January 2005 Education has yet to compare the amounts it disbursed for its 2002–03 grant to expenditure reports submitted by subrecipients. As a result, Education cannot be assured that it has disbursed the appropriate amounts to subrecipients and can make final adjustments, if necessary.

RECOMMENDATIONS

To minimize the time between subrecipients' receipt and disbursement of federal funds, Education should implement procedures to assess each subrecipient's cash needs and, if necessary, adjust a subrecipients' advance payments to more closely reflect their immediate cash needs. Additionally, Education should ensure that its subrecipients report their program expenditures in time to allow Education to assess their cash needs before making additional advance payments. Finally, if Education cannot demonstrate its ability to ensure that subrecipients minimize the time between receipt and disbursement of advance payments of federal funds, it should implement procedures to pay its subrecipients on a reimbursement basis rather than paying them in advance.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education is exploring various options for monitoring the expenditures of subrecipients before subsequent payments are issued. In fiscal year 2005–06, Education anticipates implementing a standardized method to assess the cash needs of subrecipients prior to releasing advance payments.

For the current year, Education will review fiscal year 2003–04 carryover amounts reported on the October 2004 fiscal reports, to evaluate each subrecipients cash needs prior to making additional advance payments.

Reference Number:	2004-3-8
Federal Catalog Number:	84.365
Federal Program Title:	English Language Acquisition Grants
Federal Award Number and Calendar Year Awarded:	T365A030005; 2003
Category of Finding:	Cash Management
State Administering Department:	Department of Education

CRITERIA

Our review of the English Language Acquisition Grants program identified the following requirements relating to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows a state's subrecipients to receive advance payments provided they demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Additionally, if a state's subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between receipt and disbursement of federal funds.

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that program subrecipients demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Under its payment procedures Education disburses predetermined percentages of program funds to subrecipients rather than assessing and disbursing funds based on each subrecipient's immediate cash needs. Further, Education does not require its subrecipients to report their use of program advances before it makes additional payments to them. Education's lack of procedures to assess each subrecipient's cash needs, combined with its predetermined advance-payment process, does not sufficiently ensure that subrecipients minimize the time between receipt and disbursement of federal funds.

Of the 40 expenditure transactions we reviewed for the English Language Acquisition Grants program, Education disbursed 100 percent of the funds in three payments during fiscal year 2003–04 before receiving information on the subrecipients' use of funds. Education did not require its subrecipients to report their use of program advances until October 2004, after it had disbursed the full amount of the grant. As a result, Education disbursed at least $12.1 million for the 40 transactions we reviewed with little assurance that these subrecipients minimized the time between receipt and disbursement of federal funds. Moreover, our review found that 32 subrecipients reported, as of November 2004, that they had carried over $5.4 million (44.1 percent) of grant funds from fiscal year 2003–04 to fiscal year 2004–05. The amounts that these 32 subrecipients carried over ranged from $2,336 to $1,215,509. The percentages of amounts the 32 subrecipients carried over ranged from 1.6 percent to 100 percent of the amounts Education disbursed to them in fiscal year 2003–04.

RECOMMENDATIONS

To minimize the time between subrecipients' receipt and disbursement of federal funds, Education should implement procedures to assess each subrecipient's cash needs and, if necessary, adjust its advance payments to more closely reflect each subrecipient's immediate cash needs. Additionally, Education should ensure that its subrecipients report their program expenditures in time to allow Education to assess their cash needs before it makes additional advance payments. Finally, if Education determines it cannot implement procedures to ensure that its subrecipients report program expenditures before it assesses their cash needs and makes additional advance payments, it should implement procedures to pay its subrecipients on a reimbursement basis rather than in advance.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education is exploring various options for monitoring the expenditures of subrecipients before subsequent payments are issued. In fiscal year 2005–06, Education anticipates implementing a method to assess the cash needs of subrecipients prior to releasing additional funds.

In the interim, English Language Acquisition Grants funds will be disbursed in three payments throughout the year. This approach seems to be proportionate to the expenditure needs of most of the local education agencies.

Reference Number:	2004-3-9
Federal Catalog Number:	84.298
Federal Program Title:	Innovative Education Program Strategies
Federal Award Numbers and Calendar Years Awarded:	S298A020005; 2002 S298A030005; 2003
Category of Finding:	Cash Management
State Administering Department:	Department of Education

CRITERIA

Our review of the Innovative Education Program Strategies (Innovative Education) program, identified the following requirements relating to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows a state's subrecipients to receive advance payments provided they demonstrate the ability to minimize the time between receipt and disbursement of federal funds. Otherwise, reimbursement is the preferred method of payment. Additionally, if a state's subrecipients receive advance payments, Section 80.20(b)(7) requires them to follow procedures for minimizing the time between receipt and disbursement of federal funds. Further, sections 299.1 and 299.2 state that the regulations in Section 80, with some exceptions, apply to Titles I through XIII of the Elementary and Secondary Education Act of 1965 as amended.

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that subrecipients of the Innovative Education program minimize the time between receipt and disbursement of federal funds. Under its payment procedures, Education disburses predetermined percentages of Innovative Education program funds to subrecipients rather than assessing and disbursing funds based on each subrecipient's immediate cash needs. Education does not require its subrecipients to report their use of program advances before it makes additional payments to them. As a result, Education does not ensure that subrecipients minimize the time between receipt and disbursement of federal funds.

We reviewed 40 Innovative Education program subrecipients to which Education made advance payments and found that it disbursed 80 percent of the funds during fiscal year 2003–04 without receiving information on the subrecipients' use of funds. As a result, Education disbursed approximately $747,000 with no assurance that these subrecipients minimized the time between the receipt and use of federal funds. Moreover, our review found that Education had awarded and disbursed $968,000 to the same subrecipients for fiscal year 2002–03. In total the 40 subrecipients had $409,000 (42 percent) in carryover from fiscal year 2002–03 to fiscal year 2003–04. Moreover, 11 subrecipients carried over 70 percent or more of their prior awards. The amounts that these 11 subrecipients carried over ranged from $3,188 to $57,550. The percentages that these 11 subrecipients carried over ranged from 77 percent to 263 percent of the amounts Education disbursed in the previous fiscal year.

RECOMMENDATIONS

To minimize the time between subrecipients' receipt and disbursement of federal funds, Education should implement procedures to assess each subrecipient's cash needs and, if necessary, adjust its advance payments to more closely reflect the immediate cash needs of each subrecipient. Additionally, Education should ensure that its subrecipients report their program expenditures in time to allow Education to assess their cash needs before making additional advance payments. Finally, if Education determines it cannot implement procedures to ensure that subrecipients report program expenditures in time for it to assess cash needs and make additional payments, it should consider implementing procedures to pay its subrecipients on a reimbursement basis rather than in advance.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

With limited resources available to monitor whether subrecipients' advance payments are expended before subsequent payments are issued, Education is exploring various options for an optimal approach on monitoring, which includes seeking guidance from the United States Department of Education on its expectations.

In the interim, Education continues to allocate funds proportionate to the unpaid months that have elapsed prior to and including the month of the current apportionment, based on the principle that local education agencies (LEAs) incur federal expenditures fairly constant through the year. During the 2003–04 fiscal year, Education included language in apportionment letters to notify LEAs of a potential delay in funding if significant carry over balances existed. The next step will be separate written notifications to non-compliant LEAs that will detail specific dollar amounts and percentages. Currently, our plan is to issue these notifications at the release of the second 40 percent payment.

In addition, revisions are being made to Part II of the Consolidated Application to include collection of expenditure data. Education will evaluate this data in relation to cash management issues.

Reference Number:	2004-3-11
Federal Catalog Number:	84.048
Federal Program Title:	Vocational Education—Basic Grants to States
Federal Award Numbers and Calendar Years Awarded:	V048A020005A; 2002 V048A030005A; 2003
Category of Finding:	Cash Management
State Administering Department:	California Community Colleges, Chancellor's Office

CRITERIA

Our review of the Vocational Education—Basic Grants to States program (Vocational Education) identified the following requirements related to cash management:

The Code of Federal Regulations, Title 34, Section 80.21, allows a state's subrecipients to receive advance payments, provided they demonstrate the ability to minimize the time between their receipt and disbursement of federal funds. Under its procedures to advance payments to subrecipients, the California Community Colleges, Chancellor's Office (Chancellor's Office) withholds a subrecipient's last payment until the Chancellor's Office has received and reviewed the subrecipient's final expenditure report for the fiscal year.

CONDITION

The Chancellor's Office did not always withhold a subrecipient's last payment until the Chancellor's Office received and reviewed the subrecipient's final expenditure report for the fiscal year. Specifically, we found that the Chancellor's Office paid eight of 22 subrecipients a total of $1,581,683 before reviewing and approving these subrecipients' final expenditure reports for fiscal year 2002–03. When it does not follow its policy to review subrecipients' final expenditure reports before disbursing additional federal funds, the Chancellor's Office cannot be assured that it has disbursed the appropriate amounts to subrecipients and can make final adjustments, if necessary.

RECOMMENDATION

To ensure that its has disbursed the appropriate amounts to its subrecipients and can make final adjustments, if necessary, the Chancellor's Office should ensure it follows its procedures for reviewing and approving subrecipients' final expenditure reports before releasing final payments.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The Chancellor's Office concurs. We are examining the relationship between the 4th quarter end of program report, the subsequent final program report, and the payment of the last payment to the subrecipients. We are devising a better mechanism of coordination to ensure appropriate, approvable payment.

Reference Number:	2004-5-1
Federal Catalog Number:	84.126
Federal Program Title:	Rehabilitation Services—Vocational Rehabilitation Grants to States
Federal Award Numbers and Calendar Years Awarded:	H126A020005; 2002 H126A030005; 2003
Category of Finding:	Eligibility
State Administering Department:	Department of Rehabilitation

CRITERIA

Our review of the Rehabilitation Services—Vocational Rehabilitation Grants to States program (Vocational Rehabilitation) determined that the following is among the compliance requirements for eligibility:

Title 34, Section 361.41, requires the State to determine an individual's eligibility for Vocational Rehabilitation services within 60 days of receiving his or her application, with certain exceptions.

CONDITION

The Department of Rehabilitation (Rehabilitation) does not always determine applicant eligibility for Vocational Rehabilitation services within the required period. However, ongoing efforts to improve its ability to determine eligibility promptly have had a positive impact. Specifically, of the 35,160 applications Rehabilitation received between July 1, 2003, and April 30, 2004, it did not determine eligibility, obtain extensions, or close cases within the 60-day period for 2,820 applications, or 8 percent. In fiscal years 2001–02 and 2002–03, Rehabilitation exceeded the 60-day period for 21 percent and 14.6 percent of the applications it received, respectively. Thus, Rehabilitation is making consistent improvement.

In 1,926 of the 35,160 applications (5.5 percent) it received between July 1, 2003, and April 30, 2004, Rehabilitation determined an applicant's eligibility after 60 days. For some of these cases, Rehabilitation obtained an agreed-upon extension after the deadline. Of the 1,926 cases, Rehabilitation was fewer than 11 days late in 60.7 percent of the cases, between 11 and 30 days late in another 25.1 percent of the cases, and between 31 and 60 days late in an additional 9.3 percent of the cases. Rehabilitation took more than 120 days to determine eligibility in 4.9 percent of the cases. In addition to the 1,926 cases for which it was late in determining eligibility, Rehabilitation still had not determined eligibility status in 179 cases as of July 31, 2004, and 715 cases had other resolutions after the 60-day deadline. When Rehabilitation does not determine an applicant's eligibility within the required period, it reduces the assurance that clients receive the required vocational rehabilitation services promptly.

RECOMMENDATION

To ensure that applicants receive Vocational Rehabilitation services promptly, Rehabilitation should continue with its efforts to determine eligibility within the required period.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The Department of Rehabilitation (DOR) agrees with this finding and appreciates BSA's acknowledgement of our efforts in reducing the percentage of overdue eligibility determinations. As correctly noted by BSA, DOR's ongoing efforts have resulted in a significant decline in the number of overdue eligibility determinations from 21 to 8 percent. To meet the required confidence level, DOR will continue to take the following actions to further reduce the number of overdue eligibility determinations:

Action #1—Share information with District Administrators

The District Administrators will continue to receive monthly reports that track the number of overdue eligibility determinations for prompt and immediate follow-up by Rehabilitation Supervisors and counselors.

Action #2—Inform and educate DOR staff

The importance of timely eligibility determination continues to be stressed in all DOR sponsored training courses and during staff meetings at all levels. The Case Recording Handbook, Chapter 2, also provides a full description of the presumptive eligibility provisions in the Code of Federal

Regulations (CFR). Counselors and Rehabilitation Supervisors continue to receive automated reminder notices on the Field Computer System (FCS) before the expiration of the 60 days allowed for eligibility determination.

The Employment Preparation Services (EPS) and Specialized Services Deputy Directors are working directly with District Administrators to ensure the maximum use of the presumptive eligibility and use of existing information provisions in the CFR. Counselors and Rehabilitation Supervisors are being urged to fully implement these provisions and to determine applicant eligibility based on existing information and SSI/SSDI verification at the time of application.

Action #3—Local level monitoring of eligibility determinations

The Rehabilitation Supervisors continue to conduct reviews of eligibility determinations and extensions to ensure appropriateness and compliance with federal regulations. Rehabilitation Supervisors work with the counselors to utilize existing information to the maximum extent possible and the presumptive eligibility criteria to ensure more timely eligibility determinations. Counselors and Rehabilitation Supervisors continue to receive automated reminder notices on the FCS before the expiration of the 60 days allowed for eligibility determination. In addition to the automated reminder notices, reports are generated monthly to track the number of overdue eligibility determinations in each district. These reports are shared with the District Administrators and Rehabilitation Supervisors for review and follow up. In response to previous BSA findings, these reports have been modified to include information as to whether the consumer receives SSI or SSDI to ensure that presumptive eligibility criteria is being applied in a manner consistent with the Rehabilitation Act to expedite the eligibility determination process for consumers.

Action #4—Executive level monitoring of eligibility determinations

The EPS and Specialized Services Deputy Directors will continue to review monthly overdue eligibility reports to work with the District Administrators to resolve the issues preventing the timely determination of eligibility. The District Administrators are asked to review these reports and report back to the deputy directors with corrective plans to address any overdue eligibility determination issues.

DOR recognizes the importance of meeting eligibility determination timelines and remains committed to improve in this area through a collaborative effort with District Administrators and Rehabilitation Supervisors. DOR will continue to use the action plan above to monitor, identify, and promote best practices that will contribute to obtaining compliance with this federal requirement.

Reference Number:	2004-7-1
Federal Catalog Number:	84.298
Federal Program Title:	Innovative Education Program Strategies
Federal Award Number and Calendar Year Awarded:	S298A010005; 2001
Category of Finding:	Earmarking
State Administering Department:	Department of Education

CRITERIA

Our review of the Innovative Education Program Strategies (Innovative Education) program identified the following requirements relating to earmarking:

For fiscal year 2001-02 the United States Code, Title 20, Section 7331(b), required that no more than 25 percent of funds available for the Innovative Education program be used for administration. Additionally, Section 8821 allowed the State to consolidate the administrative funds of several programs, including the Innovative Education program.

CONDITION

The Department of Education (Education) does not have adequate procedures to ensure that it meets the Innovative Education program earmarking requirements. Thus, it cannot ensure that it spends federal funds in compliance with federal regulations. For the fiscal year 2001–02 grant award, Education consolidated its state administrative funds for the Innovative Education program and several other federal programs. Using the funds from each program, it determined the proportionate share for each program and applied those proportions to the costs it incurred. For the Innovative Education program, Education consolidated the entire $5.8 million available for state use. However, based on our calculations, it should have consolidated only $1.7 million of the funds set aside for state use and should have restricted administrative expenditures to this consolidated pool. Additionally, it should have tracked separately the remaining $4.1 million for other state-level activities. Because Education failed to consolidate and track federal funds properly, the Innovative Education program may have borne a disproportionate share of the administrative costs the State incurred.

We reported a similar finding in our audits of fiscal years 2001–02 and 2002–03. For fiscal year 2001–02 Education asserted that the U.S. Department of Education (USDE) should have been aware it consolidated as administrative funds most of the allocation for state operations in the Innovative Education program since 1996. However, the USDE determined in February 2003 and informed Education that it should have consolidated as administrative funds no more than 25 percent of the amount allocated for state use.

RECOMMENDATION

Education should ensure that it consolidates for state administration no more than 25 percent of the funds set aside for its use to meet the Innovative Education program earmarking requirement.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education is no longer consolidating state administrative funds with the implementation of No Child Left Behind in fiscal year 2002–03. However, in the event that Education is authorized to consolidate state administrative funds in the future, the following procedures will ensure that no more than the amount authorized by the program statute, and related regulations and guidance will be included in that consolidation.

1. Education incorporated a new section in the *Office Manager's Guidelines* file under Federal Grant Control that provides guidance to current and future managers concerning the consolidation of state administrative funds, and documents a new requirement that there be additional reviews to ensure compliance with federal guidelines.

2. Education created a new electronic folder that contains information regarding audit findings on federal funds. This folder is filed under "Federal Grants" and provides current and future managers with historical information on audit findings.

3. Additionally, Education developed and continually updates a federal programs database that contains regulations and guidance on each federal grant, as well as links to Web sites that provide additional and updated information. The database provides management with information to determine the federal set-aside requirements for each federal grant. In the event that Education decides to consolidate state administrative funds in the future, this database will be a valuable tool in determining administrative amounts authorized by program statute.

4. Education has also taken steps to add additional professional staff, that have responsibility for tracking federal fund issues such as this, to its Budget Office.

Reference Number: 2004-7-2

Category of Finding: Level of Effort—Supplement Not Supplant

State Administering Department: Department of Education

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of federal programs identified the following requirements related to level of effort:

The United States Code, Title 20, sections 2391(a), 6321(b)(1), 6613(f), 6825(g), and 7217c provide that, with certain exceptions, funds paid to a state for the federal programs listed below must be used to supplement, rather than supplant, the level of federal, state, and local funds expended for these programs.

CONDITION

The Department of Education (Education) does not have a system in place for monitoring the State's compliance with the requirement that it use revenues from certain federal grants to supplement, rather than supplant, existing funds for grant-related activities. These grants include the Title I Grants to Local Educational Agencies, Vocational Education—Basic Grants to States, Innovative Education Program Strategies, English Language Acquisition Grants, and Improving Teacher Quality State Grants programs. By not tracking whether it is using its federal funds to supplement existing funds, the State may not identify potential noncompliance in time to take the necessary corrective action, which ultimately could result in reduced federal funding in future years. We independently performed procedures to determine whether Education met the supplement-not-supplant requirements for three grant award years closing out during fiscal year 2003–04 and preliminary reviews for two grant awards and found that the State appeared to have met these requirements.

RECOMMENDATION

Education should implement a process to monitor whether the federal grant revenues supplement other funding for the programs.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Each Education program office will determine the specific supplement requirements for its particular program, then work with fiscal staff to track and monitor state and local expenditures and state appropriations, as necessary, for compliance with the requirements. Based on the supplement requirements, Education will implement a process to monitor whether the federal grant revenues supplement, not supplant, other funding for the programs.

U.S. DEPARTMENT OF EDUCATION

Federal Catalog Number:	84.010
Federal Program Title:	Title I Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A010005; 2001

Federal Catalog Number:	84.048
Federal Program Title:	Vocational Education—Basic Grants to States
Federal Award Number and Calendar Year Awarded:	V048A010005; 2001

Federal Catalog Number:	84.298
Federal Program Title:	Innovative Education Program Strategies
Federal Award Number and Calendar Year Awarded:	S298A010005; 2001

Federal Catalog Number:	84.365
Federal Program Title:	English Language Acquisition Grants
Federal Award Number and Calendar Year Awarded:	T365A020005; 2002

Federal Catalog Number:	84.367
Federal Program Title:	Improving Teacher Quality State Grants
Federal Award Number and Calendar Year Awarded:	S367A020005; 2002

Reference Number:	2004-7-3
Federal Catalog Number:	84.027
Federal Program Title:	Special Education—Grants to States
Federal Award Numbers and Calendar Years Awarded:	H027A020116; 2002 H027A030116; 2003
Category of Finding:	Level of Effort—Maintenance of Effort
State Administering Department:	Department of Education

CRITERIA

Our review of the Special Education—Grants to States program (Special Education) identified the following requirements related to level of effort—maintenance of effort:

The United States Code, Title 20, Section 1412(a)(19)(A), prohibits any state that receives assistance under Special Education from reducing the amount of state financial support for Special Education and related services for children with disabilities, including support for the excess costs of educating those children, to less than the amount of that support for the preceding fiscal year. Further, the Code of Federal Regulations, Title 34, Section 300.154(a), specifies that the State must have on file with the U.S. Department of Education (USDE) information to demonstrate that the State will comply with this requirement.

CONDITION

The Department of Education (Education) does not have a system in place to demonstrate that the State maintains funding for Special Education and related services at a level that is at least equal to the funding for the prior year. Additionally, because not all the funding information is available and questions exist on what funding should be included in the calculation, it is too early to tell whether the State will meet this requirement for fiscal year 2002–03. Failure to meet this requirement could result in the State losing some federal funding for Special Education.

Although in previous years the budget for Special Education has steadily increased, with the recent budget reductions, the State's ability to comply with the maintenance of effort requirement has come into question. However, without specifically tracking the State's funding of Special Education and related services, Education cannot demonstrate the State is meeting the maintenance of effort requirement.

For example, the State's budget for fiscal year 2002–03 deferred paying approximately $100 million from the Department of Mental Health's budget, some of which had been used for services provided to children in Special Education, causing some to question whether the State had met its maintenance of effort requirement. Our review of preliminary budgetary information indicates that, despite the reduction of funding from the Department of Mental Health, state funding will be sufficient to meet its maintenance of effort requirement for fiscal year 2002–03. However, our preliminary analysis uses budgetary information rather than actual expenditures. According to Education, it will not have final expenditure information until July 2005. Additionally, Education told us that the calculation to determine whether it met its maintenance of effort requirement should include the portion of property taxes that are specifically designated by state law to be used for Special Education purposes. However, according to Education, final property tax information also will not be available until July 2005. Thus, we could not definitively conclude that the State will meet the requirement. Additionally, when we discussed Education's position with representatives from USDE, USDE questioned the State's inclusion of property taxes, an issue that remains unresolved.

RECOMMENDATIONS

Education should clarify with USDE the definition of the funding that serves as the basis for determining whether the State has met the maintenance of effort requirements for Special Education. Further, it should implement a system for annually monitoring the State's compliance with the requirements.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education will establish a monitoring system to ensure that the State meets the maintenance of effort requirements for the Special Education program. During this process, Education will determine the components of maintenance of effort and, if necessary, seek clarification from the federal government.

Reference Number:	2004-9-4
Federal Catalog Number:	84.126
Federal Program Title:	Rehabilitation Services—Vocational Rehabilitation Grants to States
Federal Award Numbers and Calendar Years Awarded:	H126A020005; 2002 H126A030005; 2003

Category of Finding:	Suspension and Debarment
State Administering Department:	Department of Rehabilitation

CRITERIA

Our review of the Rehabilitation Services—Vocational Rehabilitation Grants to States program (Vocational Rehabilitation) determined that the following are among the compliance requirements for suspension and debarment:

The Code of Federal Regulations, Title 34, Section 80.35, prohibits the State from doing business with any party that is suspended, debarred, or otherwise ineligible to participate in federal assistance programs. In addition, Title 34, Section 85.510, requires the State to obtain certifications from participating organizations affirming that they are not suspended, debarred, ineligible, or voluntarily excluded from transactions by any federal agency. Further, Title 34, Section 85.110, makes procurement contracts for goods or services expected to equal or exceed $100,000 subject to the suspension and debarment certification requirements.

CONDITION

The Department of Rehabilitation (Rehabilitation) did not obtain the required suspension and debarment certification from three of the four contractors we reviewed that had amendments to existing contracts or new contracts initiated during fiscal year 2003–04. In our fiscal year 2002–03 review, we also reported that Rehabilitation had not obtained the required certifications from all five contractors reviewed. In response, Rehabilitation stated that it had developed suspension and debarment language to include in all fiscal year 2003–04 contract amendments and all 2004–05 contracts that were $100,000 or more. However, two contract amendments and one new contract—together representing $1.1 million—did not have the appropriate suspension and debarment language. Without obtaining the required certifications, Rehabilitation risks unknowingly allowing suspended or debarred parties to participate in Vocational Rehabilitation. For the transactions we reviewed, we used an alternative test to determine that these participants were not suspended or debarred.

RECOMMENDATION

Rehabilitation should ensure that Vocational Rehabilitation participants receiving procurement contracts of $100,000 or more submit the required suspension and debarment certifications before Rehabilitation approves their participation in Vocational Rehabilitation.

DEPARTMENT’S VIEW AND CORRECTIVE ACTION PLAN

The Department of Rehabilitation agrees with this finding and has taken additional steps to ensure that suspension and debarment certifications are included in all contracts over $100,000. Specifically, all contract analysts have been directed to carefully and fully review each contract or amendment over $100,000 to be certain it includes suspension and debarment language. In addition, the lead contract analyst will review all contracts to ensure that the language is included. If the language is not included in the contracts, the contracts will be returned to the contract analyst to have the required language inserted into the contract and initialed by all parties.

Reference Number:	2004-13-3
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Education

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of the Vocational Education—Basic Grants to States program (Vocational Education) and the Education Technology State Grants program (Education Technology) identified the following requirements relating to subrecipient monitoring:

The Code of Federal Regulations, Title 34, Section 80.40(a), requires the State to monitor subrecipient activities supported by federal program funds to ensure that they comply with applicable federal requirements and meet performance goals. Additionally, the U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133), Section 400(d), requires the State to identify federal award information to subrecipients at the time of the award. This includes such information as the Catalog of Federal Domestic Assistance (CFDA) title and number, award name and number, and name of the federal awarding agency.

CONDITION

The Department of Education (Education) did not adequately fulfill its subrecipient monitoring responsibilities for Vocational Education and Education Technology. Specifically, Education did not identify all required federal award information in award letters to subrecipients. Owing to staff oversight, Education did not identify the U.S. Department of Education as the federal awarding agency and did not provide the CFDA number and title or relevant regulations for any of its Vocational Education subrecipients. Also, none of the 40 grant award letters we reviewed for Education Technology contained CFDA numbers and titles. When Education does not identify the federal award information, it cannot ensure that subrecipients of Vocational Education or Education Technology funds correctly identify all their federal grant awards. As a result, subrecipients' independent auditors, who must conduct audits in accordance with OMB Circular A-133, may not be aware of all grants they must consider for audit. The State uses the independent audits as one method to monitor subrecipients' compliance with applicable federal requirements and program goals.

RECOMMENDATION

Education should ensure that it identifies and provides all required federal award information to subrecipients of Vocational Education or Education Technology funds at the time of the awards.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

As stated in the condition, the required federal award information was inadvertently omitted in the Vocational Education 2003–04 final grant award notification letters because this letter was combined with the eligible recipient's application approval information letter. However, Education is now sending out separate letters to transmit the final grant award notification and application approval information. The annual final grant award notification letters mailed to eligible recipients of the Carl D. Perkins Vocational and Technical Education Act Section 112, 131, and 132 funds includes the required federal award information. The letter states:

> Your agency's _(year)_ Perkins III allocation is part of the Vocational Education Basic Grant to States from the Office of Vocational and Adult Education (OVAE), United States Department of Education (USDE). The Catalog of Federal Domestic Assistance (CFDA) number is 84.048. The Vocational Education Basic Grant to States funds are subject to Title 34 Code of Federal Regulations (CFR) 400 and 403; Education Department General Administrative Regulations (EDGAR) 74, 76 (except 76.103), 77, 79-82, and 85; Office of Civil Rights (OCR) Guidelines for Vocational Education; and compliance requirements discussed in Office of Management and Budget (OMB) circulars A-87 and A-133.

Beginning with the 2004–05 Education Technology State Grants, Education will post the CFDA title and number, award name and number, and name of the federal agency on the grant award letters sent to subrecipients.

U.S. DEPARTMENT OF EDUCATION

Federal Catalog Number:	84.048
Federal Program Title:	Vocational Education—Basic Grants to States
Federal Award Number and Calendar Year Awarded:	V048A030005; 2003

Federal Catalog Number:	84.318
Federal Program Title:	Education Technology State Grants
Federal Award Numbers and Calendar Years Awarded:	S318X020005A; 2002 S318X030005; 2003

Reference Number:	2004-13-4
Federal Catalog Number:	84.010
Federal Program Title:	Title I Grants to Local Educational Agencies
Federal Award Number and Calendar Year Awarded:	S010A030005A; 2003
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Education

CRITERIA

Our review of the Title I Grants to Local Educational Agencies program (Title I, Part A) determined that the following compliance requirements relate to the comparability of school services and subrecipient monitoring:

The United States Code, Title 20, Section 6321(c), requires local educational agencies (LEAs) that receive Title I, Part A funds to use state and local funds to provide school services that are at least comparable to services provided by schools not receiving these federal funds, unless otherwise excluded. In addition, this section states that an LEA will have met the requirement of comparability if the LEA has filed with the state education agency a written assurance that the LEA has established and implemented an LEA-wide salary schedule and a policy to ensure equivalence among schools in the provision of curriculum materials and instructional supplies, among other things. Further, this section states that each LEA must develop procedures and maintain records documenting compliance with the requirements.

In addition, the U.S. Office of Management and Budget Circular A-133, A*udits of States, Local Governments, and Non-Profit Organizations*, Section 400(d), requires the State to monitor the activities of subrecipients to ensure compliance with laws and regulations.

CONDITION

The Department of Education (Education) has not monitored whether LEAs receiving Title I, Part A funds have complied with the requirement to provide school services that are at least comparable to services provided by schools not receiving these federal funds.

During fiscal year 2003–04 Education required LEAs that received Title I, Part A funds to file with Education specific written assurance that the LEAs had established and implemented an LEA-wide salary schedule; a policy to ensure equivalence among schools in teachers, administrators, and other staff; and a policy to ensure equivalence among schools in the provision of curriculum materials and instructional supplies. However, Education has not established and implemented procedures to monitor the LEAs' compliance with these requirements.

When Education does not monitor the LEAs' compliance, it cannot be sure that LEAs receiving Title I, Part A funds have established and implemented the policies and procedures federal law requires to ensure comparable school services.

RECOMMENDATION

Education should establish and implement a Title I, Part A monitoring process to ensure that LEAs receiving these federal program funds provide school services that are at least comparable to the services provided by schools not receiving Title I, Part A funds.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

In the fall of each year, Education collects student and teacher data from all schools through the California Basic Educational Data System (CBEDS). This information is sufficient for Education to calculate a comparability report for each local education agency (LEA) every year regarding student-teacher averages, thus reducing the reporting burden on LEAs. LEAs that successfully meet the comparability requirement based on the comparability report will be finished with the reporting process for the current school year. For LEAs that fail to meet the comparability requirement based on the comparability report, the Title I Policy and Partnerships Office will contact the LEA for additional information to document compliance. Additional information may include a correction of the student-teacher ratio data that is more current or accurate than obtained by Education to calculate the comparability report. The LEA may also provide a fiscal report that compares Title I schools to a group average of non-Title I schools. Education is seeking technical assistance from the United States Department of Education in the analysis and interpretation of data submitted by the LEAs to ensure that the LEAs meet the comparability requirements.

Additionally, Education will incorporate comparability into its program monitoring process on an ongoing basis. Beginning with the school year 2005–06, the revised program monitoring process will include a Title I comparability element for the review of the implementation of consolidated programs in LEAs for the school year 2004–05 and subsequent school years.

Reference Number:	2004-13-5
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Education

(See listing of the specific program details following the discussion of the issues below.)

CRITERIA

Our review of the Special Education—Grants to States program and the Special Education—Preschool Grants program identified the following requirements relating to subrecipient monitoring:

The Code of Federal Regulations, Title 34, Section 80.40(a), requires the State to monitor subrecipient activities supported by federal program funds to ensure that they comply with applicable federal requirements and meet performance goals. The U.S. Office of Management and Budget Circular A-133, A*udits of States, Local Governments, and Non-Profit Organizations*, Section 400(d) requires the State to monitor the activities of subrecipients to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and grant agreements and that performance goals are achieved.

In the grant award eligibility documents that it submitted to the U.S. Department of Education, the California Department of Education (Education) indicated that its monitoring system or quality assurance process is composed of four major or essential components: the local plan, the coordinated compliance self-review (self-review), compliance complaints, and focused monitoring (verification reviews). Additionally, its grant award eligibility documents state that 25 percent of the subrecipients submit their self-reviews annually.

CONDITION

Education does not monitor the activities of its subrecipients awarded funds from the Special Education—Grants to States program and the Special Education—Preschool Grants program in accordance with grant award eligibility documents. Specifically, for fiscal year 2003–04 Education collected revisions to subrecipients' local plans, investigated complaints, and performed verification reviews. Although these activities, along with the self-review, represent Education's monitoring system, Education did not require any of its subrecipients to submit self-reviews during fiscal year 2003–04. Thus, it did not perform one of the monitoring functions that its grant award eligibility documents indicated was an essential component of its quality assurance process. According to various staff in Education's Special Education Division, during fiscal year 2003–04 Education collected mental health data and contacted subrecipients to remind them to have Individualized Education Plans (IEPs) conducted on time as required and to submit corrective action plans when necessary. Education believes these procedures were sufficient to replace the requirement that subrecipients perform self-reviews. However, we remain unconvinced that the collection of mental health data and Education's reminders of late IEPs and corrective action plans are sufficient to replace the self-review process. Consequently, for fiscal year 2003–04, Education's monitoring process did not provide reasonable assurance that subrecipients are complying with applicable federal requirements and meeting performance goals.

RECOMMENDATION

Education should ensure that it sufficiently monitors the activities of subrecipients awarded funds from the Special Education—Grants to States program and the Special Education—Preschool Grants program to provide reasonable assurance that the subrecipients administer federal awards in compliance with laws, regulations, and the provisions of grant agreements and that peformance goals are achieved.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Since Education was revamping its self review process, Education contacted the U.S. Department of Education regarding the change in the self review process as stated in the grant award eligibility documents. Education believed the U.S. Department of Education accepted the fact that it was requiring the designated districts scheduled for self review to submit mental health data to be monitored and reviewed by Education staff. In addition, Education monitored all subrecipients through the submission of data on all children with disabilities, local plans for all Special Education Local Plan Areas (SELPAs) and their constituent local education agencies (LEAs), and service delivery and budget plans for all SELPAs and LEAs.

For fiscal year 2004–05, Education developed new procedures and software to align the self review process with the verification review process. Key to the processes is the software package that will assist in the development and implementation of a self review monitoring plan that customizes the review for each district based on data and parent input. The software package generates the items and forms used to conduct the self review and will be used for reporting the districts' findings to Education.

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

We contacted the U.S. Department of Education concerning Education's suspension of its self-review process for fiscal year 2003–04. The U.S. Department of Education would not confirm that it approved Education's actions nor could Education provide us with evidence of the U.S. Department of Education's approval.

U.S. DEPARTMENT OF EDUCATION

Federal Catalog Number:	84.027
Federal Program Title:	Special Education—Grants to States
Federal Award Numbers and Calendar Years Awarded:	H027A020116; 2002 H027A030116; 2003

Federal Catalog Number:	84.173
Federal Program Title:	Special Education—Preschool Grants
Federal Award Numbers and Calendar Years Awarded:	H173A020120; 2002 H173A030120; 2003

Reference Number:	2004-14-3
Federal Catalog Number:	84.032
Federal Program Title:	Federal Family Education Loans
Year Awarded:	State fiscal year 2003–04
Category of Finding:	Special Tests and Provisions
State Administering Department:	California Student Aid Commission

CRITERIA

Our review of the Federal Family Education Loans program (loan program) identified the following compliance requirements related to special tests and provisions:

The Code of Federal Regulations, Title 34, Section 682.414, requires guaranty agencies, such as the California Student Aid Commission (Student Aid), to maintain current, complete, and accurate records for each loan they hold. Good internal controls over information systems would include strong general controls, which are the structure, policies, and procedures that apply to an entity's overall computer operations. Some of the major categories of general controls are entitywide security program planning and management, and access controls.

Further, the California Education Code, Section 69522, authorized Student Aid to establish a nonprofit auxiliary organization to administer activities associated with the loan program. This section also requires the operations of the auxiliary organization to be conducted in conformity with an operating agreement approved annually by Student Aid and requires Student Aid to oversee the operations of the auxiliary organization.

CONDITION

Student Aid's auxiliary organization administers the loan program. However, the auxiliary organization has not developed adequate internal controls over its information systems to provide reasonable assurance that it keeps current, complete, and accurate records of each loan. Specifically, we found weaknesses in the auxiliary organization's controls over entitywide security planning and management, and restriction of access to computer software and data files. We also found weaknesses in the operating agreement between Student Aid and its auxiliary organization. These weaknesses hamper Student Aid's ability to ensure that the auxiliary organization maintains strong controls over its information systems.

The auxiliary organization's management has not provided sufficient entitywide security planning and management. We found that although the auxiliary organization has made some progress, it has yet to complete a comprehensive security risk assessment or an entitywide security program plan. This plan should clearly describe the auxiliary organization's security program and the policies and procedures that support it. In addition, the plan should cover all major facilities and systems and outline the duties of the security management function. The lack of planning and management has led to insufficient protection of sensitive or critical computer records. In May 2004 the auxiliary organization created an Information Security Steering Committee, sponsored by executive management, to address information security issues. Additionally, the auxiliary organization issued a request for proposal seeking a vendor to conduct a comprehensive information security risk assessment and develop a comprehensive Information Security Awareness program for both the auxiliary organization and Student Aid. On January 3, 2005 the auxiliary organization awarded a contract to assess information security risks. However, the auxiliary organization has yet to award a contract to develop a comprehensive Information Security Awareness program.

In August 2003 the auxiliary organization hired a director of information security. Among the director's responsibilities are, developing and assisting in formulating and implementing of information security procedures and standards, as well as for facilitating processes to manage and mitigate security risk. Good business practices dictate that an information security officer be responsible to the auxiliary organization's president, and be of a sufficiently high classification that he or she can execute the responsibilities of the office in an effective and independent manner. However from his appointment through September 2004, the director of information security reported to the vice president of technology solutions and services. This reporting relationship was not ideal because the director of information security could report security issues that were not also communicated to the auxiliary organization's president. As of October 1, 2004, the auxiliary organization appropriately modified its organizational structure so that the director of information security now reports directly to the auxiliary organization's president.

The auxiliary organization has strengthened its physical security controls in response to weaknesses we reported in previous years. For example, the auxiliary organization moved the computer room tape library to an adjacent secured room separate from other computer equipment, and installed external video cameras to monitor and record access to the main computer room. However, activity within the computer room remains unmonitored by either electronic surveillance or by personnel stationed within the computer room. Because the computer room still contains a variety of equipment, such as telecommunications equipment, various servers, and the mainframe, individuals with authorized access to the telecommunications equipment, for example, will also have unsupervised access to the servers and mainframe.

The auxiliary organization also needs to strengthen its logical security controls. Logical security controls are the policies and electronic access controls designed to restrict access to computer software and data files. Although the auxiliary organization had made some changes, it continued to have the following weaknesses in controls over its software and data files during fiscal year 2003–04:

- It does not always promptly remove employees' electronic access when they transfer or leave the employ of the auxiliary organization. We tested a sample of 29 employees who had left the employ of the auxiliary organization and found that in two cases the auxiliary organization did not promptly remove the employees' electronic access. For these employees, the auxiliary organization took 104 and 10 days to remove access after the employees left the employ of the auxiliary organization.

- Until September 2004, three employees from one division had the ability to add, change, or delete information from student loan data and the information system's master files. This level of access can allow for inappropriate modification of sensitive loan data and system files. However, during September 2004, the auxiliary organization corrected this situation by separating the duties of the three employees. Specifically, two employees kept access to student loan data and their access to the information system master files was deleted. The third employee kept access to the system's master files and access to the student loan data was deleted.

- It has not developed preventative controls that would help prohibit the 52 employees with a total of 135 guaranteed student loans from modifying or deleting their own borrower information. In addition, the auxiliary organization has not completed reviews that could promptly identify whether student loan data has been modified inappropriately. However, the auxiliary organization has taken some steps to mitigate this weakness by putting a policy in place that calls for the dismissal of any employee who attempts to alter or have altered by another party his or her own loan records. Additionally, the auxiliary organization continues its process instituted in April 2003 that identifies if an employee's guaranteed student loan is delinquent so that the auxiliary organization can work with the employee to bring the loan current. However, neither of these steps is sufficient to prevent an employee from modifying or deleting their own loan records.

- A limited number of employees are allowed access to data and tables in the system that is not related to their assigned responsibilities. Additionally, until June 2004, the auxiliary organization inappropriately allowed these same employees to make changes to sensitive data such as student loan and user security information, that were not subject to the normal edits of its information system. Further, the auxiliary organization did not maintain a complete history or audit trail of the changes made to the data for a sufficient period of time to allow for the audit of these changes. On June 21, 2004, the auxiliary organization implemented changes that partially address our concerns. Specifically, it implemented a new process creating an automated audit trail to track some of the changes staff made to this sensitive data while it also reduced the ability of staff to make other types of modifications. However, according to the auxiliary organization's assistant vice president of applications development, due to the age and complexity of the information technology system, to limit staff access to only the data that is pertinent to their assigned responsibilities would require significant and costly changes to the information technology system and may require more than one year to complete.

Finally, Student Aid's operating agreement with the auxiliary organization does not include provisions to ensure that the auxiliary organization maintains strong controls over its information systems. In fiscal year 2002–03, we noted that the operating agreement did not detail Student Aid's expectations for the operation of the information technology system that maintains the records for the loan program. Such expectations could include requirements for information security, the performance of a security risk assessment, and development of an information security program plan. We also noted that Student Aid could require its auxiliary organization to obtain an audit of its information technology controls that are relevant to Student Aid's financial statements. This audit should report on whether such controls were suitably designed to achieve specified control objectives, whether they have been enacted as of a specific date, and whether the controls were sufficient to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified. Student Aid extended its operating agreement with the auxiliary organization for fiscal year 2003-04 without adding any provisions to strengthen controls over information systems. Student Aid believes there are sufficient provisions in the existing operating agreement to ensure the auxiliary organization maintains strong control over its information systems. However, the operating agreement does not identify performance measures or expectations for critical areas such as the operation of Student Aid's Financial Aid Processing System (FAPS). Performance measures should be quantifiable and reported on a regular basis to Student Aid. Absent such provisions, Student Aid may have limited recourse if FAPS or other critical activities did not perform as planned.

RECOMMENDATIONS

Student Aid's auxiliary organization should implement an entitywide program for security planning and management that addresses the required independence of the security management function and provides for strong physical and logical security controls over its information systems. This will ensure that it maintains current, complete, and accurate records for each loan that it holds. In addition, Student Aid should amend its operating agreement with its auxiliary organization to specify its expectations related to the control structure over the information system.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Comprehensive Security Risk Assessment and Entity-wide Security Program Plan

Student Aid's auxiliary has contracted with a third-party contractor to perform a comprehensive security risk assessment. The contract became effective on January 3, 2005. Recommendations resulting from the assessment will be used in formalizing an entity-wide security program plan. In addition, the auxiliary will develop and implement a comprehensive information security awareness program for its employees during the federal fiscal year ending September 30, 2005.

Information Security Officer

The auditors are correct in that the Director of Information Security is now the auxiliary's designated Information Security Officer and reports to the President of the auxiliary effective October 1, 2004.

Computer Room Monitoring

The Commission agrees that monitoring the computer room would strengthen internal controls. The auxiliary has, therefore, purchased and installed security cameras within the data center. The installation was complete on December 15, 2004 and the cameras are now being used.

Removal of Employee Electronic Access

A procedural change was made beginning September 15, 2003 to expedite employee electronic access removal. The two incidents identified by the auditors occurred prior to this change.

Segregation of Duties

The auditors are correct in that the matter has been resolved by separating the duties of the three employees. This change was made during September 2004.

Preventative Controls

The Commission continues to believe that a preventative control of the scope described may not be warranted. The following, however, will be undertaken during the federal fiscal year ending September 30, 2005 to address the concern:

- Research and determine industry standards pertaining to such controls of similar organizations.

- Evaluate the efficacy of implementing the controls recommended by the auditors, looking at the system capability, time and resources necessary to do so, as well as review any such options in light of the information gained from the industry standards research.

- Internal Audit will periodically sample and review system activity on loans associated with auxiliary employees. Although not a preventative control, the results of Internal Audit's review will provide support for the decision as to whether additional preventative controls are necessary or cost effective.

Data and Table Maintenance

The auditors are correct in that the auxiliary implemented a new process creating an automated audit trail to track table changes.

During the federal fiscal year ending September 30, 2005, the auxiliary will perform the following activities regarding data maintenance:

- Inventory the key data maintenance changes

- Determine the cause(s) and criticality of such changes
- Determine the volume of such changes and associated risk(s)

The Commission believes that it is necessary to perform these activities before any additional controls over data maintenance can be evaluated and/or implemented.

Operating Agreement

The Commission's operating agreement with the auxiliary organization has not been amended but was extended for one more year. The Commission believes that there are sufficient provisions in the Operating Agreement to appropriately enforce the auxiliary to maintain strong control over its information systems.

Reference Number:	2004-14-4
Federal Catalog Number:	84.011
Federal Program Title:	Migrant Education—State Grant Program
Federal Award Number and Calendar Year Awarded:	S011A030005; 2003
Category of Finding:	Special Tests and Provisions
State Administering Department:	Department of Education

CRITERIA

Our review of the Migrant Education—State Grant Program (Migrant Education) determined that the following compliance requirement related to the subgrant process:

The United States Code, Title 20, Section 6394(b)(5), requires the State to determine the amount of subgrants it awards to local educational agencies (LEAs) and take into account the numbers and needs of migratory children, the priority for services for certain migratory children, and the availability of funds from other federal, state, and local programs.

CONDITION

The Department of Education (Education) did not take into account all the required information when it awarded subgrants to LEAs for Migrant Education. During fiscal year 2003–04, Education allocated funds to LEAs using current data on the numbers and needs of migratory children in the State. However, although Education uses its applications to obtain limited information about the availability of funds from other federal, state, and local programs, it did not consider the information when it determined the amount of subgrants it awarded to LEAs. In addition, Education did not take into account the priority for services of migratory children in the State when it determined the subgrant amounts awarded to LEAs. As a result, Education cannot be sure it appropriately funded the LEAs that had the greatest needs when it determined the subgrants for Migrant Education.

RECOMMENDATION

Education should ensure that it obtains sufficient information about the availability of funds from other federal, state, and local programs and takes this information and the priority for services into account when it determines the size of subgrants it awards to LEAs for Migrant Education.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education has a mechanism to obtain information on the availability of funds from other federal, state and local programs, and is developing a system to identify the number of students who meet the Priority for Services criteria. However, it is unclear how this information is to be used when determining the amount of a subgrant to LEAs for the Migrant Education program. Education is contacting the United States Department of Education's Office of Elementary and Secondary Education Migrant Education program office to seek clarification and guidance on how to use this information when determining the amount of a subgrant.

U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Reference Number:	2004-1-1
Federal Catalog Number:	93.778
Federal Program Title:	Medical Assistance Program
Federal Award Number and Calendar Year Awarded:	05-0405CA5028; 2003
Category of Finding:	Activities Allowed
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Medical Assistance Program (Medicaid) identified the following compliance requirement related to activities allowed:

The United States Codes, Title 42, Section 1396b(o) requires that if an individual eligible for Medicaid has other health coverage, such as a private insurer, providers must bill the other health care coverage before billing Medicaid.

CONDITION

The Department of Health Services (Health Services) applied too broadly a modification to its claims-processing system. As a result, since April 2004, Health Services has been inappropriately paying Medicaid claims for services provided to certain children under its Medical Therapy Program (MTP) without attempting to bill other health coverage first. Conducted primarily in public schools, the MTP is a state program that provides medically necessary occupational and physical therapy as well as physician consultations to children with conditions such as cerebral palsy, neuromuscular conditions, and chronic musculoskeletal and connective tissue diseases. Health Services has allowed counties to bill Medicaid for covered MTP services provided to Medicaid-eligible children since 1994. However, realizing that many of these claims for reimbursement were denied because counties submitted them before determining whether the children were covered by other health care insurers that would pay for the MTP services, Health Services modified its claims-processing system so that beginning in April 2004, it would no longer reject such claims. Health Services justified the system modification on compliance with federal law when claims are for MTP services to children in special education, reasoning that children in special education with therapy identified as a component of an individualized education program are entitled to a "free and appropriate" education. According to Health Services, billing a child's other health care insurer could result in the family incurring a cost for therapy, such as a deductible or a copayment. Consequently, Health Services decided that other health care insurers should not be billed for MTP services because of the possible financial burden to families. Although we agree that this action is appropriate under federal law when claims are for services to MTP children receiving special education services, Health Services has not obtained the necessary federal approval to apply the modification when claims are for service to MTP children not in special education.

As a result, Health Services is improperly allowing Medicaid to pay claims for services to MTP children who are not in special education without first determining whether other available health care insurance plans will pay.

When we asked Health Services about obtaining federal approval for applying the system modification when claims are for children not in special education, Health Services acknowledged it had not obtained federal approval in this case. Health Services asserted it did not obtain federal approval because the federal government had denied a similar request in the past and it told Health Services it was too busy to respond to such requests. Further, Health Services indicated it had to make the change for the whole MTP population because neither Health Services nor its fiscal agent can distinguish between those children who are in special education and those who are not when a claim is processed. Finally, Health Services asserts that other health care insurers do not cover the kinds of services the MTP provides. Nevertheless, because it has not obtained federal approval to apply this modification when claims are for services to MTP children who are not in special education, Health Services is in violation of federal laws designed to ensure that Medicaid is the payer of last resort.

Because neither Health Services nor its fiscal agent can distinguish between those children who are in special education and those who are not when claims are processed, we are not able to determine the amount of questioned costs related to these claims.

RECOMMENDATIONS

Health Services should obtain federal approval for allowing Medicaid to pay for MTP services provided to children who are not in special education without checking for the existence of other health coverage. Otherwise, Health Services should modify the current claims-processing system to ensure that other available health insurance is charged before Medicaid pays for MTP services provided to children who are not in special education.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services does not believe that obtaining federal approval is promising because, on issues similar to this, the federal Centers for Medicare and Medicaid Services (CMS) has advised Health Services that it would not review a waiver request from the State because of workload considerations. Health Services maintains that it would not be productive to develop and submit a waiver request to CMS on this issue since CMS would not consider it. Further, Health Services states that the claims-processing system has no access to a database that would enable the system to determine whether an individual Medicaid beneficiary participates in special education. Health Services further believes that the cost of developing such a system would exceed any foreseeable benefit experienced by the nominal increase of federal participation.

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

As we already stated, not all children in the MTP receive special education services. Therefore, Health Services is improperly allowing Medicaid to pay claims for services to MTP children who are not in special education without first determining whether other available health care plans will pay. Lacking the necessary federal approval to implement its current process, Health Services needs to take the appropriate steps to comply with Medicaid requirements. Additionally, Health Services has not indicated whether it intends to modify its current claims-processing system to ensure compliance with Medicaid requirements.

Reference Number:	2004-1-2
Federal Catalog Number:	93.767
Federal Program Title:	State Children's Insurance Program
Federal Award Numbers and Calendar Years Awarded:	05-03A5CA5021; 2003 05-04A5CA5R21; 2004
Category of Finding:	Activities Allowed
State Administering Department:	Department of Health Services

CRITERIA

Our review of the State Children's Insurance Program identified the following compliance requirement related to activities allowed:

The Code of Federal Regulations, Title 42, Section 457.1, requires that, within broad federal rules, each state decides payment levels for benefit coverage, among other items.

CONDITION

The Department of Health Services (Health Services) does not always ensure that the provider information and rates it uses to calculate payments for certain services provided under the State Children's Insurance Program are current. Specifically, for one of 10 invoices we tested, Health Services paid the provider using a rate that was 14 percent more than the correct rate. As a result, Health Services overpaid this provider more than $48,000 for this one invoice. According to Health Services, this provider should only have one active provider number for inpatient services and it was unaware that the provider had two active numbers for inpatient services. Although Health Services updated the rates for the original provider number, the second active provider number had outdated rates. The provider submitted its invoice using the second number and therefore Health Services used the old rate to calculate the provider's payment. Health Services also indicated that it plans to recover this overpayment. At the completion of our fieldwork, Health Services had not yet determined the extent of other overpayments, if any, it made to this provider.

For a second invoice, Health Services had not updated certain rates in its system for the provider. For providers that do not have a contract with Health Services, Health Services pays the lower of the amount of a provider's invoice or a maximum amount it calculates using established rates. Although our review of this invoice indicated that Health Services paid the provider correctly because it paid the invoice amount, which was lower than the calculated maximum amount, it may have incorrectly paid this provider for other invoices because it failed to update the rates in its system.

Finally, for another three invoices, Health Services was unable to provide us with documentation to support some of the rates it used in calculating the amounts paid to the providers. As a result, we were unable to verify the accuracy of $35,807 that Health Services paid to providers for these three invoices.

RECOMMENDATIONS

Health Services should follow through on its plan to collect the overpayment and determine the extent of other overpayments, if any, it made to this provider for other invoices. Additionally, Health Services should deactivate the provider number with old rates. Further, Health Services should ensure that it updates the rates in its system that it uses to calculate amounts it pays to providers and it should maintain documentation to support those rates.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The Department confirms the first finding. The circumstances described in this finding were made known to the Department on March 2, 2005. The claim in question was billed with CGP inpatient provider number CGP019420 which should have been end dated when the provider was issued a second CGP inpatient provider number, CGP007260. While updates to the interim rate adjustment in 1998, 1999, 2000, 2001, and 2004 were correctly entered in the provider master file (PMF) for this second CGP provider number, they were not entered in the PMF for CGP019420. The Department will enter the interim rate adjustment updates in the PMF for CGP019420. When this is accomplished the Department will request that its fiscal intermediary contractor implement an erroneous payment correction (EPC) cycle in the California Medicaid Management Information System (CA-MMIS) to debit or credit the provider for any overpayments or under payments, including the one in the auditor's sample, made for claims billed by the provider with provider number CGP019420. When this is accomplished provider number CGP019420 will be deactivated.

The Department confirms the second finding. The Department received a request from the provider in question to update the accommodation codes and usual and customary charges for those codes in the PMF for CGP inpatient provider number CGP136785 in May 2002. An update of the PMF was initiated by the Department at that time, but was not completed because of some indeterminate technical problem with the PMF update. The Department will again initiate an update of the accommodation codes and usual and customary charges in the PMF for CGP136785. When this update is completed, the Department will request that its fiscal intermediary contractor implement an EPC cycle in CA-MMIS to debit or credit the provider for any over payments or under payments made for claims billed by the provider with provider number CGP136785 resulting from not entering the 2002 accommodation code and usual and customary charge update requested by the provider.

In the third finding the auditor is requesting hard copy documentation (i.e., the accommodation code change request received from the individual provider) to support requested updates of the accommodation codes and usual and customary charges in the electronic PMF for CGP inpatient provider numbers CGP021035, CGP000355, and CGP007260. The Children's Medical Services Branch received this request from the auditor on 03/02/05. If the hard copy documentation requested by the auditor is available, the Department will provide that material to the auditor.

In July 2004, the Department implemented major changes for the adjudication of CCS provider claims. The CA-MMIS system was modified to allow providers to bill for CCS services using Medi-Cal provider numbers. CCS offices are now issuing service authorizations linked to the providers Medi-Cal provider number and the providers are using their Medi-Cal provider numbers to bill for CCS services. CGP inpatient provider numbers will be deactivated by September 2005. This will eliminate the possibility of future interim reimbursement rate and accommodation code errors analogous to those cited by the auditor.

AUDITOR'S COMMENTS ON THE DEPARTMENT'S VIEW

Health Services states that its Children's Medical Services branch received our request for documention to support payment rates for the ten claims we reviewed on March 2, 2005. However, we first requested the documentation from Health Services on February 15, 2005. Our final request for this information, which we still had not received as of March 17, 2005, was on March 2, 2005.

Reference Number:	2004-1-5
Federal Catalog Number:	93.778
Federal Program Title:	Medical Assistance Program
Federal Award Numbers and Calendar Years Awarded:	05-0305CA5028; 2002 05-0405CA5028; 2003
Category of Finding:	Activities Allowed
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Medical Assistance Program (Medicaid) identified the following compliance requirements related to activities allowed:

The U.S. Office of Management and Budget Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments* (OMB Circular A-87) states that a given cost is reasonable if it is generally recognized as ordinary and necessary for the operation of the governmental unit or the performance of the federal award. Additionally, the U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations, Compliance Supplement* (Circular A-133 Compliance Supplement) states that a Medicaid cost is allowable when it applies to an allowable medical service rendered and supported by medical records or other evidence indicating that the service was actually provided and consistent with the medical diagnosis.

CONDITION

The Department of Health Services (Health Services) did not always ensure that services approved for Medicaid beneficiaries were medically necessary. We requested that Health Services conduct field reviews of client records and other pertinent documents to substantiate the medical necessity of the services billed to the Medicaid program for the 30 claims we reviewed.

Health Services' review revealed that one of the 30 claims did not have adequate support to substantiate the medical necessity of the service paid for by the Medicaid program. In this case, Health Services found that the Medicaid beneficiary received Adult Day Health Care (adult day) services that were not medically necessary. Health Services stated that the patient's medical status did not put her at high risk for skilled nursing facility confinement and that there was no clear documentation that the patient could not obtain her medical care through traditional outpatient medical care providers. Although the amount Health Services paid for this claim was only $158, Health Services acknowledged that enrolling and rendering unnecessary services is a common problem with adult day providers. Thus, according to an audit manager at Health Services, its' Audits and Investigations Unit is beginning to place a greater emphasis on these types of providers by conducting postpayment reviews and investigations.

Additionally, in our fiscal year 2002–03 review, we reported that Health Services did not always ensure that services approved for Medicaid beneficiaries were supported by sufficient documentation. As part of its corrective action, Health Services stated that it would develop cases on the providers with systemic findings and subject them to a comprehensive reviews of paid claims to prevent any further unnecessary utilization. Health Services also stated that it promptly takes action when it identifies a systemic problem with a Medicaid provider. As of February 2005 Health Services had not yet conducted comprehensive reviews of the providers identified with systemic findings. It has, however, initiated case development for these providers.

RECOMMENDATIONS

Health Services should continue to emphasize reviews of adult day providers to ensure that adult day providers enroll and provide adult day services only to those Medicaid beneficiaries whose medical conditions require this level of care. Health Services should also ensure that systemic weaknesses identified during reviews of Medicaid provider records are promptly corrected and that it seek restitution from providers if services are not medically necessary or properly documented.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

DHS' review of 30 randomly selected fee for service claims determined that one claim for Adult Day Health Center (ADHC) services rendered to a Medi-Cal beneficiary was medically unnecessary.

We agree with the BSA recommendations.

ADHC services are approved based on submitting Treatment Authorization Requests (TAR) to the Medi-Cal field office. The field office must rely on the accuracy of the documentation submitted by the ADHC and/or physicians when determining the medical necessity of a patient. The only way to guarantee medical necessity prior to approving an ADHC service is through an on-site TAR approval process and seeing the patient face-to-face. On-site TAR approvals are labor intensive and cannot be acomplished with current staffing.

However, Audits and Investigations (A&I) is continuing its post payment focus on ADHC providers. A&I, Investigation Branch (IB) has conducted over 30 ADHC reviews in 2003/2004. The majority of IB's reviews of ADHCs have resulted in a recovery of overpayments. In addition, several branches of DHS are combining efforts to conduct comprehensive reviews on selected ADHCs. The review will be an unannounced inspection that will target the facility staffing and program violations. The project is currently in the planning phase. It is anticipated that the first reviews will occur in March 2005. Branches of DHS participating in the joint effort are: IB, Medical Review Branch (MRB), Licensing & Certification (L&C), Financial Audits Branch (FAB) and Medi-Cal Field Services. Also, the Medicare Safeguard Contractor has contributed data to this project to identify potential duplicate and fraudulent billings.

DHS is also in the process of trying to change the current ADHC rate methodology. The current ADHC all-inclusive rate was set based on the California Association for Adult Day Services (CAADS) lawsuit against DHS regarding the rate setting methodology used by DHS for ADHCs services. In 1993, the case was settled and new rates for ADHCs services were established. A State Plan Amendment (SPA) is being developed to change the current rate development methodology. The SPA will primarily:

- Redefine services to be rehabilitative in nature.
- Unbundle the current all-inclusive rate into individual service rates for which providers will have to bill separately.
- Develop a new rate setting methodology.
- Eliminate those services for which there is no federal financial participation (FFP).

The SPA will also further define medical necessity to reflect a rehabilitation care plan. The SPA is being mandated by the Centers for Medicare and Medicaid Services (CMS) to ensure FFP for the ADHC program.

In the 2004–05 budget year, a one-year moratorium on certification of new ADHCs servicing Medi-Cal beneficiaries was established. ADHCs continued to receive licenses but were not able to serve Medi-Cal beneficiaries. The moratorium is renewable annually until the SPA is ready for implementation.

Legislation is also pending for authority to make the changes in the SPA. If the legislation is passed, the SPA will be submitted to CMS. DHS is estimating approval for the SPA by spring of 2006. System billing changes are estimated to take at least one year with implementation of the new billing methodology by the summer of 2007.

In the fiscal year 2002–03 review, DHS determined there were three claims with systemic findings in the sample of claims selected by the BSA. In the corrective action plan, DHS was to initiate cases on the three providers. Field Audit Review (FAR) cases were not established until February 2005. It is anticipated that the three providers will be reviewed by the FAR committee and assigned to a MRB field office in March 2005.

Reference Number:	2004-1-6
Federal Catalog Number:	93.778
Federal Program Title:	Medical Assistance Program
Federal Award Numbers and Calendar Years Awarded:	05-0205CA5028; 2001 05-0305CA5028; 2002 05-0405CA5028; 2003
Category of Finding:	Activities Allowed
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Medical Assistance Program (Medicaid) identified the following compliance requirements related to activities allowed:

The Code of Federal Regulations, Title 42, Part 438, Subpart A, allows states to contract with managed care health plans (health plans) to provide health care to Medicaid beneficiaries. Under the terms of these contracts, the Department of Health Services (Health Services) pays the health plans a monthly capitation payment for each Medicaid beneficiary. The contracts allow Health Services to recover overpayments of any capitation payment it makes to the health plans.

CONDITION

In our fiscal year 2002–03 audit we reported that Health Services did not recover overpayments of Medicaid funds paid to health plans as capitation payments for beneficiaries who had died and thus were no longer eligible for Medicaid. As a result, Health Services allowed health plans to retain Medicaid funds to which they were not entitled. Specifically, based on information provided by Health Services, we found that between August 2002 and August 2003, Health Services made monthly capitation payments to health plans for deceased beneficiaries 16,454 times. According to Health Services, the average monthly capitation payment paid to health plans was approximately $100. Consequently, Health Services paid at least $1,645,400 for deceased beneficiaries during this period. Health Services had not recovered any of these payments. Staff at Health Services said that the backlog of overpayments for deceased members might extend as far back as 1999. Health Services' Managed Care Division, which is responsible for recovering overpayments, informed us that it had assigned staff to identify the extent of the overpayments and develop a method for recovering the overpayments, pending management approval. Additionally, Health

Services stated that it was implementing a process that will enable it to identify overpayments monthly, thus allowing it to recover the overpayments more quickly. During our 2003–04 audit, we found that Health Services had implemented this new process in April 2004.

In our fiscal year 2002–03 audit, we recommended that Health Services continue its efforts to determine the full extent of monthly capitation payments made to health plans for deceased beneficiaries and immediately implement procedures to recover the overpayments. Health Services concurred with our recommendation. However, during our fiscal year 2003–04 audit, it came to our attention that Health Services had not yet recovered the overpayments. Instead, Health Services determined that its best course of action was not to recoup past capitation overpayments because doing so would expose Health Services to lawsuits. However, Health Services has not obtained federal approval to forgive the overpayments. Consequently, the federal government may require Health Services to return these funds, which represent costs that were not allowable.

RECOMMENDATION

Health Services should obtain federal approval to forgive past capitation overpayments.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Medi-Cal Managed Care agrees with the condition statement that managed care health plans were overpaid capitation for deceased Medi-Cal Managed Care Plan members. The Department has taken the necessary steps to ensure that all future capitation payments for deceased Medi-Cal Managed Care Plan members are offset against future capitation payments (retroactive to the first month after the month of death) to the plans once a deceased member's status is corrected on Medi-Cal Eligibility Data System. For incorrect capitation payments made for deceased Medi-Cal Managed Care Plan members prior to the date of the modification allowing for capitation offsets, the Department has been advised by the Office of Legal Services that significant legal exposure to lawsuits that would be expected to be filed by the managed care health plans exists should the department attempt to recoup the capitation overpayments. Consequently, Medi-Cal Managed Care Division will not pursue recovery of these overpayments. The Department will contact the Centers for Medicare and Medicaid Services to determine what avenues to pursue in order to forego collection of these overpayments.

Reference Number:	2004-3-10
Federal Catalog Number:	93.778
Federal Program Title:	Medical Assistance Program
Federal Award Numbers and Calendar Years Awarded:	05-0305CA5028; 2002 05-0405CA5028; 2003
Category of Finding:	Cash Management
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Medical Assistance Program (Medicaid) identified the following compliance requirements related to cash management:

The Cash Management Improvement Act (CMIA) agreement between the State and federal government, sections 8.4 and 8.6, establish the conditions giving rise to the State's interest liability on all refunds for Medicaid and provide the methods for calculating the interest liability.

The Department of Finance (Finance) requires state departments to report information related to the receipt and disbursement of federal funds so that Finance can calculate the State's interest liability under the CMIA agreement.

CONDITION

Our review of the refund portion of worksheets that the Department of Health Services (Health Services) submitted to Finance for Medicaid found that Health Services did not always accurately report the dates for five of 12 months during fiscal year 2003–04.

Specifically, Health Services incorrectly reported the warrant-issued date for 25 refund transactions included on the worksheets for the months of October, November and December 2003, as well as January and April 2004. When Health Services does not accurately report the warrant-issued dates, it causes Finance to incorrectly calculate the amount of the State's interest liability. If we had not informed Finance of the errors and the errors remained uncorrected, it would have understated the State's interest liability by $31,749.

RECOMMENDATION

Health Services should ensure that the quarterly worksheets it submits to Finance accurately report warrant-issued dates.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Accounting met with the Department of Finance to discuss the date that should be used and the reasoning behind using the "Warrant-issued dates". It was determined and agreed upon that Accounting will use the "Warrant-issued dates"; however, in most instances Accounting will now show the refunds and adjustments on the line associated with the Medi-Cal checkwrite. This will be the case unless the refunds and adjustments against that line item cause a credit amount in the "Net Warrant Amount" column. If a credit amount were to occur, then a portion of the refund or adjustment will be moved to the next larger amount with a "Warrant issue date" closest to the "Date Bank Recv'd". When the refunds and adjustments are shown against the Medi-Cal Checkwrite amount, the "Warrant-issued date" and the "Date Bank Recv'd" should be the same date and will result in the lowest amount of interest liability for the State.

Reference Number:	2004-5-2
Federal Catalog Number:	93.044
Federal Program Title:	Special Programs for the Aging—Title III, Part B—Grants for Supportive Services and Senior Centers
Federal Award Numbers and Calendar Years Awarded:	02-03-AA-CA-1320; 2002 04AACAT3SP; 2003
Category of Finding:	Eligibility
State Administering Department:	Department of Aging

CRITERIA

Our review of the Special Programs for the Aging—Title III, Part B—Grants for Supportive Services and Senior Centers identified the following compliance requirement related to eligibility:

The United States Code, Title 42, Section 3026(a)(8)(C), states that case management services will be provided by a public agency or a nonprofit private agency.

CONDITION

The Department of Aging (Aging) does not have procedures to ensure that case management providers are public or nonprofit private agencies. According to the program specialist, Aging was unaware of the requirements for it to screen case management providers for public or nonprofit private status. As a result, Aging may not have complied with federal requirements for eligibility. For the nine Area Agencies on Aging we reviewed, we performed procedures to verify that their case management providers were, in fact public agencies or nonprofit private agencies.

RECOMMENDATION

To ensure that case management providers are public or nonprofit private agencies, Aging should develop procedures to screen case management providers for their public or nonprofit private status.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Title III B Case Management contracts will be modified to include these requirements to ensure that the Department is in compliance with the United States Code, Title 42, Section 3026(a)(8)(C). The Department will: 1) prepare a Program Memo to communicate these requirements to the Area Agencies on Aging (AAA); 2) integrate the requirements into the Department's monitoring tools; 3) examine other tools to ensure compliance; and 4) follow up with AAA's if monitoring reveals any cases where this requirement has not been met.

Reference Number:	2004-5-3
Federal Catalog Number:	93.778
Federal Program Title:	Medical Assistance Program
Federal Award Numbers and Calendar Years Awarded:	05-0305CA5028; 2002 05-0405CA5028; 2003
Category of Finding:	Eligibility
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Medical Assistance Program (Medicaid) identified the following compliance requirement related to eligibility:

The Code of Federal Regulations, Title 42, Section 435.916(a), requires a state agency to redetermine the eligibility of Medicaid recipients, with respect to circumstances that may change, at least every 12 months.

CONDITION

The Department of Health Services (Health Services) is the single state agency designated to supervise the administration of the State's Medical Assistance Program (Medicaid) in accordance with all aplicable provisions and federal regulations for the program. In its administration Health Services delegates the day-to-day operation of the program to county welfare departments (counties). However, Health Services maintains full responsibility for ensuring a county's federal compliance with all Medicaid program requirements, including those relevant to client eligibility determinations. Our review of three of the 33 small counties not subject to Medicaid eligibility quality control reviews found that Placer County did not always ensure that it redetermined Medicaid eligibility at least once every 12 months. Specifically, although the eligiblity redetermination for the Medicaid recipient we tested was due by March 2004, as of October 2004 Placer County had not yet performed the redetermination—seven months beyond the due date. During that time the Medicaid recipient received $79 in benefits. According to one of Placer County's program managers, the county's case data system did not always automatically generate due dates to inform county staff when redeterminations on Medicaid recipients were due. The program manager also stated that the county took corrective action to address this problem when it became aware of the issue prior to our audit. However, at the time of our review, Placer County had not yet applied corrective action to the one case we selected for review. Finally, the program manager also stated that Placer County discontinued Medicaid eligibility for this case in November 2004 and is implementing a new case data system in January 2005 that should resolve this problem.

RECOMMENDATION

Health Services should ensure that Placer County performs redeterminations of Medicaid recipients at least every 12 months, as required.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The Department agrees with the Bureau of State Audit's (BSA) finding and conclusion regarding the need for Placer County to conduct timely and accurate annual eligibility redeterminations. In view of the BSA's audit findings in Placer County, the Department plans to make immediate contact with the county to discuss plans for annual redeterminations and any issues the county may have regarding compliance with the redetermination process. The Department anticipates that the compliance review will consist of a random sample of 100 Medi-Cal Assistance Only cases in all aid categories with continuous Medi-Cal eligibility for 13 or more months. The cases will be reviewed to determine if the county completed the mandatory annual redeterminations on accurate and timely bases. Remedial action will be recommended based upon the findings of our review.

Based upon the outcome of this review, if the county fails to achieve acceptable accuracy and timeliness rates, a follow-up review would automatically be scheduled within a reasonable time.

Reference Number:	2004-12-2
Category of Finding:	Reporting
State Administering Department:	Department of Education

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of the Child Care Mandatory and Matching Funds of the Child Care and Development Fund program and the Child Care and Development Block Grant program determined that the following compliance requirement relates to reporting:

The U.S. Department of Health and Human Services (HHS) Administration for Children and Families Child Care and Development Fund Terms and Conditions require that each state submit an original financial status report (ACF-696) detailing expenditures on a quarterly basis.

CONDITION

The Department of Education (Education) did not report accurate data in its ACF-696 for fiscal year 2000–01, which it submitted on October 29, 2003. Because its management failed to ensure the accuracy of the report, Education overstated the State's share of expenditures by more than $6 million. After we brought this error to the attention of Education, it submitted a corrected report.

RECOMMENDATION

Education should ensure that it adequately reviews its required reports for accuracy before submitting them to HHS.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The reporting error occurred when the accountant was preparing reports for two different grant years. Inadvertently, the accountant typed the wrong grant information at the top of the report, and as a result, the back-up documentation was attached to the wrong reports. Since the error was made in a quarterly report, rather than a final report, Education was able to correct the problem. In the future, all final financial status reports will be reviewed by the accountant's manager and a second level manager.

U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Federal Catalog Number:	93.575
Federal Program Title:	Child Care and Development Block Grant
Federal Award Number and Calendar Year Awarded:	2001 G996005; 2001

Federal Catalog Number:	93.596
Federal Program Title:	Child Care Mandatory and Matching Funds of the Child Care and Development Fund
Federal Award Numbers and Calendar Years Awarded:	2001 G999004; 2001 2001 G999005; 2001

Reference Number:	2004-12-5
Federal Catalog Number:	93.767
Federal Program Title:	State Children's Insurance Program

Federal Award Numbers and Calendar Years Awarded:	05-03A5CA5021; 2003 05-04A5CA5R21; 2004
Category of Finding:	Reporting
State Administering Department:	Department of Health Services

CRITERIA

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local governments, and Non-Profit Organizations*, Compliance Supplement (Circular A-133 Compliance Supplement), requires the State to submit the Centers for Medicare and Medicaid Services (CMS-21) report titled *Quarterly Children's Health Insurance Program Statement of Expenditures for Title XXI*.

The Code of Federal Regulations, Title 45, Section 74.21 requires that the recipients' financial management system provide for accurate, current and complete disclosure of the financial results of each project or program sponsored by the U.S. Department of Health and Human Services. In addition, the financial management system must provide accounting records that are supported by source documentation.

CONDITION

The Department of Health Services (Health Services) does not ensure that amounts reported on its quarterly CMS-21 report are correctly classified. Although the total amounts spent on the program reported by Health Services are accurate, we were unable to verify the accuracy of detailed expenditures reported by line item or category of service. Our review of the four quarterly reports for fiscal year 2003–04 revealed that Health Services was unable to provide supporting documentation for amounts totaling approximately $850,000 that it reported in the Inpatient Hospital Services category. Further, whatever Health Services incorrectly reported in the Inpatient Hospital Services category, it misstated that amount in at least one other category of service.

According to Health Services, it does not receive enough information from its fiscal intermediary to be able to reconcile and accurately report program expenditures by category of service as required. Health Services is aware of the issue and is working to obtain additional information from its fiscal intermediary to resolve the differences so that it can accurately report all information on its quarterly CMS-21 report.

RECOMMENDATION

Health Services should work with its fiscal intermediary to obtain reports that it can use to accurately report all program expenditures by category of service.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The Department agrees with the finding.

The differences between information reported on the MR-O-421 and the MR-H-145 has been discussed by Payment Systems Division and the Accounting Office. An Interim Problem Statement was prepared by the Payment Systems Division, on December 10, 2004. An Interim Response was prepared by EDS on 12/31/2004. Although progress is being made, the problem has not yet been resolved.

Reference Number:	2004-13-1
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Education

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of the Child Care Mandatory and Matching Funds of the Child Care and Development Fund program and the Child Care and Development Block Grant program (child care cluster programs) determined that the following compliance requirement relates to subrecipient monitoring:

The Code of Federal Regulations, Title 45, Section 98.11(b)(4), requires the Department of Education (Education) to ensure that the child care cluster programs comply with all federal requirements and Education's Child Care and Development Fund Plan (plan), which was submitted to and approved by the U.S. Department of Health and Human Services. In the approved plan, Education committed to reviewing every three years each contractor providing local child care and development services.

CONDITION

Education does not adequately monitor subrecipients of the child care cluster programs. For instance, Education has not performed compliance-monitoring reviews (CMR) as frequently as established in its plan. We found that for eight of the 10 subrecipients we reviewed, Education did not conduct CMRs within the required three-year period. In fact, according to an analysis provided by staff at Education, more than 27 percent of the 123 CMRs it conducted in fiscal year 2003–04 occurred after the three-year deadline had expired. Failure to perform CMRs in accordance with its plan may prevent early detection and correction of deficiencies in the services provided by subrecipients.

RECOMMENDATION

Education should ensure that it conducts CMRs at least every three years, in accordance with its plan.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Education managers and consultants have been reminded of the review intervals and the need to comply with current requirements. Managers and staff have thoroughly discussed the development and monitoring of the review schedules in unit meetings, and implemented a tracking system to help schedule the reviews within the required timelines, and monitor CMR deadlines. The Field Services Unit managers monitor review schedules and data to help ensure CMR requirements are being met.

During fiscal year 2004–05, the entire Field Services Unit was redirected for a period of several months to conduct an error rate study of child care and development programs pursuant to Senate Bill 1104. Due to this priority, a similar examination of compliance review intervals for fiscal year 2004–05 would reveal that some reviews were not conducted in a timely fashion. We have informed the Department of Finance and legislative staff about this fact. They have agreed that the redirection of staff for the error rate study required by Senate Bill 1104 is the higher priority.

U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Federal Catalog Number:	93.575
Federal Program Title:	Child Care and Development Block Grant
Federal Award Number and Calendar Year Awarded:	2003 G996005; 2003

Federal Catalog Number:	93.596
Federal Program Title:	Child Care Mandatory and Matching Funds of the Child Care and Development Fund
Federal Award Numbers and Calendar Years Awarded:	2003 G999004; 2003 2003 G999005; 2003

Reference Number:	2004-13-6
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Aging

(See listing of the specific federal program details following the discussion of the issue below.)

CRITERIA

Our review of the Special Programs for the Aging—Title III, Part B—Grants for Supportive Services and Senior Centers; Special Programs for the Aging—Title III, Part C—Nutrition Services; and the Nutrition Services Incentive Program (aging programs) identified the following compliance requirements related to subrecipient monitoring:

The United States Code, Title 42, Section 3027(a)(4), requires the State to conduct periodic evaluations of activities and projects carried out under Title III of the Older Americans Act. The Code of Federal Regulations, Title 45, Section 1321.3, defines periodic as, at a minimum, once each fiscal year. However, in a letter to the Department of Aging (Aging), the U.S. Administration on Aging has agreed that Aging's description of its evaluation activities, which includes on-site evaluations every two years, is in compliance with the federal requirements for monitoring the supportive and nutrition services funded by the aging programs. Finally, Title 45, Section 1321.11, requires the State to establish policies that address the manner in which it will monitor the performance of all programs and activities funded by the aging programs for quality and effectiveness. Furthermore, the State is responsible for enforcement of these policies.

CONDITION

Aging is not adequately fulfilling its responsibility to monitor the Area Agencies on Aging (area agencies). Curently, two units within Aging are responsible for performing on-site monitoring of the area agencies. The audits unit performs audits with financial and compliance components and the monitoring unit performs program evaluations of the area agencies. Aging considers that it has met the federal requirements for monitoring when both units have completed their reviews. However, we found that for 24 of the 33 area agencies, Aging did not perform either one or both of these reviews every two years as required. As of June 2004 Aging is between one and 28 months late with these reviews.

Failure to conduct timely on-site evaluations may prevent early detection and correction of deficiencies in the services provided by the area agencies.

RECOMMENDATION

To ensure that it complies with applicable federal laws and regulations, Aging should conduct on-site reviews every 24 months as required.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The Department of Aging (Department) has examined its processes and has implemented various efficiencies to leverage limited staff resources and improve monitoring coverage of Area Agencies on Aging (AAA). We are continuing to implement the following actions in response to recent fiscal constraints that have impacted our ability to address existing workload:

Concerning Program Monitoring

- Monitoring teams triage and visit those AAAs most in need of monitoring first.

- Monitoring protocols have been streamlined and the Department continues to work on ways to further streamline protocols and make activities more efficient.

- We are developing procedures for in-office desk reviews of certain documents submitted by AAAs that could reduce the time needed during the monitoring field visits.

- In light of reduced resources, staff is also exploring how it could use annual desk reviews and other means to identify either problem AAAs that need immediate attention or exemplary AAAs that could be site-monitored less frequently than a “normal” visit schedule would dictate. In addition, it may be that a smaller, less comprehensive on-site monitoring (for instance, review of specific program areas vs. all programs operated by the AAA) will provide targeted assistance and monitoring of potential problem areas without the need for a full survey. The Department would need to seek approval from Administration on Aging (AoA) for any alternative it would propose to the two-year minimum on-site monitoring requirement.

Concerning Financial Audits

- Fiscal audit staff has developed a risk-based model to assist in prioritizing audits. The date of the last visit will be one of the factors considered in the analysis.

- Prior to scheduling audits, staff is now requiring AAAs to self-certify whether the required fiscal monitoring of their subrecipients has been performed. This pre-site visit review will allow audit staff to work with problem AAAs to correct deficiencies earlier on rather than wait until field work is complete and final reports are issued.

- AAAs are being required to submit financial documents for desk review prior to scheduling audit site visits to reduce time on the audit site.

- Audit staff and program staff are exploring ways to complement their respective monitoring activities, thereby increasing efficiency.

- Existing audit staff resources have recently been redirected toward Older American Act audit work.

In addition to the above, constraints on travel and staffing freezes that existed in 2003–04 and contributed to the lack of site visits no longer exist.

Even though staff constraints have impacted our ability to do timely reviews, the Department recognizes the priority of monitoring programs every two years. In light of the limited resources, we plan to open discussions with AoA to address this and explore alternative ways to meet the monitoring mandate. In the meantime, we will continue to pursue the above actions to improve monitoring of AAAs and we will continue to explore ways to make this process more efficient.

U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Federal Catalog Number:	93.044
Federal Program Title:	Special Programs for the Aging—Title III, Part B—Grants for Supportive Services and Senior Centers

Federal Award Numbers and Calendar Years Awarded:	02-03-AA-CA-1320; 2002 04AACATSP; 2003

Federal Catalog Number:	93.045
Federal Program Title:	Special Programs for the Aging—Title III, Part C—Nutrition Services
Federal Award Numbers and Calendar Years Awarded:	02-03-AA-CA-1712; 2002 02-03-AA-CA-1713; 2002 04AACAT3SP; 2003

Federal Catalog Number:	93.053
Federal Program Title:	Nutrition Services Incentive Program
Federal Award Numbers and Calendar Years Awarded:	03AACANSIP; 2003 04AACANSIP; 2004

Reference Number:	2004-13-11
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Community Services and Development

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of the Low-Income Home Energy Assistance and Community Services Block Grant programs identified the following compliance requirements for subrecipient monitoring:

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133), describes the requirements the State must follow when it awards federal funds to subrecipients. Specifically, OMB Circular A-133 requires the State to ensure that subrecipients spending $300,000 or more in federal assistance in fiscal year 2002–03 meet applicable audit requirements, including the submission of an audit report to the State within nine months following the end of the audit period. Also, the State is required to issue management decisions on audit findings within six months of receiving the audit reports and must ensure that the subrecipient takes timely andappropriate and timely corrective action.

CONDITION

The Department of Community Services and Development (Community Services) did not have an adequate system to ensure that it met the OMB Circular A-133 requirements it must follow when it awards federal funds to subrecipients. Specifically, Community Services did not have adequate procedures for ensuring that it obtained the OMB Circular A-133 audit reports from subrecipients within the required nine-month period. Of the 22 audit reports we sampled for the Low-Income Home Energy Assistance and Community Services Block Grant programs, Community Services received three audit reports that were between 77 and 257 days late. The late reports were the result, in part, of Community Services not having formal procedures for following up with subrecipients that have not submitted audit reports on time. In addition, despite some improvement from the previous year, Community Services still did not always review subrecipients' OMB Circular A-133 audit reports in time to issue any necessary management decisions within the required six-month period. As of January 21, 2005, Community Services was between 14 and 153 days late in reviewing three of the 22 audit reports we sampled for the Low-Income Home Energy Assistance Program and Community Services Block Grant programs.

Further, Community Services did not ensure that four of 12 subrecipients with findings took appropriate and timely corrective action. In each of four cases, Community Services requested the subrecipients to respond in writing to findings within 30 days of its management decision. However, as of January 21, 2005, two subrecipients that owed a total of $8,043 in disallowed costs were 112 and 264 days late in submitting their responses to Community Services. Although Community Services received responses from the other two subrecipients, the responses were 116 and 256 days late. Community Services sent a letter that reminded one of the four subrecipients that a response was due; however, it did so 228 days after its initial letter to the subrecipient. In addition, Community Services did not follow up with the other three subrecipients by sending any formal status or reminder letters notifying the subrecipients that their written responses were past due. Although Community Services had evidence that it communicated by e-mail with two of the subrecipients about responding to the findings, these communications did not fully address the corrective actions taken by the subrecipients. Additionally, we would expect to see a formal letter from Community Services if it reached any agreement with a subrecipient. Because Community Services did not have adequate procedures for following up with subrecipients, it did not ensure that all subrecipients took appropriate and timely corrective action on findings. Consequently, Community Services cannot be certain that federal funds have been charged appropriately.

Finally, Community Services could not provide sufficient evidence to support its decision to waive the repayment of approximately $350,000 in federal funds for one subrecipient's disallowed costs. As early as 1995, Community Services identified inappropriate transactions between a subrecipient and the subrecipient's wholly owned for-profit subsidiary for Low-Income Home Energy Assistance services. Community Services determined the majority of the costs were not allowable because the transactions resulted in a profit to the wholly owned subsidiary and determined the remaining costs did not meet other guidelines for allowable costs. However, because the subrecipient disagreed with Community Services' decision not to allow the costs, Community Services obtained a legal opinion in May 2002 to resolve the dispute. The legal opinion stated that a subrecipient is not allowed to use subcontracts with a controlled corporation to create a profit that may then be redirected back to the subrecipient, because by doing so the subrecipient could effectively avoid state and federal requirements that strictly control the use of those funds. Despite this legal opinion, in November 2004 Community Services officially forgave the repayment of approximately $350,000 in federal funds, primarily because Community Services erroneously told the subrecipient many years ago that some of these transactions were allowable. When we asked to review the relevant information it relied on to make its decision, Community Services could not provide us with sufficient supporting documentation, including details of the specific erroneous information it once provided to the subrecipient.

In January 2005, after we brought this issue to its attention, Community Services stated that it plans to reverse its decision to forgive the $350,000. However, Community Services may have a more difficult time collecting the amount due because it already communicated in writing its final decision to the subrecipient. Additionally, if Community Services does not collect amounts that were not spent according to program requirements, the federal government may require the State to return that portion because Community Services could not support its decision to forgive the repayment of disallowed costs.

RECOMMENDATIONS

Community Services should develop formal policies and procedures for following up with subrecipients when subrecipients do not submit OMB A-133 audit reports or respond to its management decisions on time.

Community Services should develop formal policies and procedures for ensuring that it reviews all OMB A-133 audit reports on time.

In the future Community Services should obtain and retain sufficient evidence to support its decision to forgive the repayment of disallowed costs. Additionally, Community Services should proceed with its plan to reverse its decision to forgive the $350,000 in disallowed costs and ultimately collect the appropriate amount.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Community Services Responses to Bureau of State Audits Recommendations (in bold):

1. **Community Services should develop formal policies and procedures for following up with subrecipients when subrecipients do not submit OMB A-133 audit reports or respond to its management decisions on time.** *CSD agrees with this recommendation and will develop policies and procedures for following up with subrecipients that do not submit timely audit reports or respond to management decisions on time.*

2. **Community Services should develop formal policies and procedures for ensuring that it reviews all OMB A-133 audit reports on time.** *CSD agrees with this recommendation and will develop formal policies and procedures for ensuring that it reviews audit reports on time.*

3. **In the future, Community Services should obtain and retain sufficient evidence to support its decision to forgive the repayment of disallowed costs. Additionally, Community Services should proceed with its plan to reverse its decision to forgive the $350,000 in disallowed costs and ultimately collect the appropriate amount.** *CSD agrees with this recommendation and will fully document all decisions to forgive the repayment of disallowed costs. CSD has already proceeded with its decision to reverse its previous position regarding the $350,000, including efforts to collect the disallowed costs. CSD understands BSA's concerns and is confident that there will be no state liability regarding the funds in question.*

U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Federal Catalog Number:	93.568
Federal Program Title:	Low-Income Home Energy Assistance
Federal Award Number and Calendar Year Awarded:	G-03B1CALIEA; 2003

Federal Catalog Number:	93.569
Federal Program Title:	Community Services Block Grant
Federal Award Number and Calendar Year Awarded:	G-03B1CACOSR; 2003

Reference Number:	2004-13-13
Federal Catalog Number:	93.778
Federal Program Title:	Medical Assistance Program
Federal Award Numbers and Calendar Years Awarded:	05-0305CA5028; 2002 05-0405CA5028; 2003
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Medical Assistance Program (Medicaid) identified the following compliance requirements related to subrecipient monitoring:

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133), requires subrecipients spending $300,000 or more in federal assistance to submit audit reports to the State. If an audit finds that a subrecipient has failed to comply with federal program requirements, OMB Circular A-133 also requires the State to issue a management decision regarding the resolution of the audit findings within six months of receiving the audit report and to ensure that the subrecipient proceeds with appropriate corrective action promptly.

CONDITION

The Department of Health Services (Health Services) does not have a formal process to ensure that Medicaid subrecipients take appropriate corrective action to findings identified in OMB Circular A-133 audit reports. During our fiscal year 2003–04 audit, we selected a sample of OMB Circular A-133 audit reports received by the State Controller's Office (Controller's Office) for federal programs we review. The Controller's Office notifies state departments of audit findings associated with the programs they administer. Our review of one item for Medicaid revealed that Health Services received notification of the audit finding but had not followed up with the subrecipient. This occurred because it does not have formal procedures to follow up on audit findings. After our inquiry on the status of the subrecipient's corrective action, Health Services contacted the subrecipient and indicated to the Controller's Office that it had reviewed the subrecipient's corrective action plan. According to the chief of Health Services' Audit Review and Analysis Section, Health Services plans to prepare formal written procedures for following up on audit findings it receives from the Controller's Office to ensure that subrecipients take prompt and appropriate corrective action.

Because it does not have a formal process for ensuring that Medicaid subrecipients respond to audit findings by taking appropriate corrective action promptly, Health Services has less assurance that its subrecipients are complying with applicable laws and regulations.

RECOMMENDATION

Health Services should continue its plan to prepare written formal procedures for following up on notifications it receives from the Controller's Office regarding findings from OMB Circular A-133 audit reports.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services agrees with this recommendation. Formal written procedures are in the process of being developed, with a targeted completion date of March 1, 2005. A copy of these procedures will be provided to the Bureau of State Audits upon completion.

Reference Number:	2004-13-14
Federal Catalog Number:	93.917
Federal Program Title:	HIV Care Formula Grants
Federal Award Number and Calendar Year Awarded:	5X07HA00041-13; 2003
Category of Finding:	Subrecipient Monitoring
State Administering Department:	Department of Health Services

CRITERIA

Our review of the HIV Care Formula Grants program identified the following compliance requirements related to subrecipient monitoring:

The U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Nonprofit Organizations* (OMB Circular A-133) requires the State to monitor the activities of subrecipients to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved. The Department of Health Services (Health Services) has established policies for administering the HIV Care Formula Grants program. Among other things, these policies set a goal for Health Services to conduct a site visit of each case management and care services subrecipient every 18 months and three years, respectively. Further, in its state application for grant funds, Health Services specified a goal to conduct 50 visits each year to enrollment sites for the AIDS drug assistance program, with each enrollment site receiving a visit at least every five years.

Additionally, U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133), Section 400 (d), requires the State to inform each subrecipient of specific federal award information, including the Catalog of Federal Domestic Assistance (CFDA) title and number, the award name and number, and the name of the federal agency.

CONDITION

We identified Health Services' site visit goals as a key component of its subrecipient monitoring process for the HIV Care Formula Grants program. However, Health Services is not performing site visits as frequently as its goals state. Specifically, we found the following:

- Health Services did not conduct site visits within the last 18 months for 10 of 20 subrecipients of the case management program that received funding in fiscal years 2002–03 and 2003–04. Of the 10 late site visits, Health Services conducted three visits within 21 months and another three within 30 months of the previous site visit. We could not determine when Health Services had conducted the previous site visit for the remaining four subrecipients.

- Health Services did not conduct site visits for 11 of the 37 subrecipients of the care services program within the last three years. Of these 11 subrecipients, Health Services conducted financial reviews for two within the last three years.

- Health Services did not conduct site visits for 34 of the 132 enrollment sites of the AIDS drug assistance program within the last five years. Additionally, Health Services did not achieve its goal because it conducted only eight of the 50 targeted site reviews during fiscal year 2003–04.

According to Health Services, the state's budget crisis in recent fiscal years limited its ability to maintain adequate staffing levels, as well as restricting travel for its existing staff as a means of meeting its performance goals.

Because it does not conduct site visits with the frequency it has established in its performance goals, Health Services has less assurance that subrecipients are complying with applicable laws, regulations, and provisions of contracts or grant agreements.

Finally, Health Services did not inform all subrecipients of specific federal award information, including the CFDA title and number, the award name and number, and the name of the federal agency, even though it was required to do so. In our review of 31 sample contracts, we found 11 contracts in which Health Services did not convey any of the required information to the subrecipients. When Health Services does not provide subrecipients with information related to the federal grant, it cannot ensure that subrecipients will identify all their federal awards for independent auditors conducting audits under the OMB Circular A-133.

RECOMMENDATIONS

Health Services should ensure that it conducts site visits in accordance with its established performance goals. Health Services may also want to reassess its policies related to subrecipient monitoring to determine if the current frequency of site visits is reasonable. Finally, Health Services should ensure that it conveys all required federal award information to its subrecipients at the time of the award.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The Office of AIDS (OA) concurs with the findings. Specific program responses are as follows:

1. Case Management Program (CMP)

CMP's self-established goal is to visit each sub-recipient site at least once every 18 months. This is not a federal requirement. To date, six of the ten sites have been visited. Of the four remaining sites not visited, one has since left the program; the remaining three sites will be visited by May 31, 2005.

In response to the finding that requires the State to inform each sub-recipient of specific federal award information, CMP has sent letters to the fiscal year 2004–05 contractors notifying them of the required information. Notification letters will be sent to the fiscal year 2003–04 contractors by March 15, 2005.

2. Care Services Program (CSP)

CSP is reviewing its self-established goal of monitoring all sub-recipients at least once every three years. Although this schedule is preferable, given staff resources, it is increasingly unlikely that the program can meet this expectation (see #4 below). Bureau of State Audits found that 11 of the 37 CSP sub-recipients were not visited within the last three years. CSP plans to conduct the remaining 11 site visits by December 31, 2005.

In response to the finding that requires the State to inform each sub-recipient of specific federal award information, notification letters will be sent to the appropriate contractors by March 15, 2005.

3. AIDS Drug Assistance Program (ADAP)

ADAP anticipates that it will need to modify its goal of visiting all program enrollment sites at least once every five years, and conducting at least 50 visits to ADAP enrollment sites each year. Although this schedule is preferable, given the staff resources available and other required duties, it is increasingly unlikely that the program can meet this self-established goal. Currently, sites first visited are those that have not been visited within the past five years and that have the highest volume of enrollment activity (currently defined as more than 50 enrollments in the most recent year). If it is unrealistic to visit all sites meeting this profile, the program will consider redefining "high volume," and/or examining the enrollment data available to look for unusual patterns at the targeted sites (e.g., most clients certifying they receive "no income" rather than providing income documentation). This may help the program "fine tune" prioritization of the sites that need to be visited. The 34 ADAP sites identified as top priority for fiscal year 2003–04 will receive a site visit by March 31, 2006.

A letter informing our ADAP contractor of specific federal award information will be sent by March 15, 2005.

4. Combined responses for CMP, CSP and ADAP

In response to the Bureau of State Audits finding that the OA did not meet their internal programmatic site visit monitoring goals. The State's budget situation in recent fiscal years limited OA's ability to maintain adequate staffing levels and restricted staff's ability to travel to meet its performance goals for CMP, CSP, and ADAP. Although OA's annual site visit goals were not met, programs relied upon daily contact with contractors, detailed review of invoices and backup documentation, progress reports, and telephonic monitoring of contractors to adequately provide fiscal and programmatic oversight. Additionally, ADAP and CSP fund a full-time auditor assigned by Health Service's Audits and Investigation (A&I) Division to perform in-depth financial audits of contractors.

OA's HIV Care Branch programs (CMP, CSP, and ADAP) are examining the feasibility of consolidating site visits by staff from various programs in an effort to maximize staff resources. The Branch's Quality Management Team is currently examining the lists of various grantees/sites to identify programs that provide services under more than one HIV Care Branch program. HIV Care Branch programs are also comparing the site visit tools used by each program to identify commonalities and determine the feasibility of creating a site visit tool that would work for more than one program.

Reference Number:	2004-14-1
Federal Catalog Number:	93.563
Federal Program Title:	Child Support Enforcement
Federal Award Number and Calendar Year Awarded:	75-X-1501; 2003

Category of Finding: Special Tests and Provisions

State Administering Department: Department of Child Support Services

CRITERIA

The Code of Federal Regulations, Title 45, Section 303.7(a), requires the Department of Child Support Services (DCSS) to establish an interstate central registry responsible for receiving, distributing, and responding to inquiries on all incoming interstate cases. Further, DCSS must respond to inquiries from other states within five working days of receipt of a request for a case status review.

CONDITION

In our review of 20 requests from other states for case status reviews, we found that for 13 requests DCSS did not indicate the dates it received the requests; therefore, we were unable to determine whether DCSS responded within five days. For the remaining seven requests, DCSS took more than the required five days to respond to two requests, taking eight days for one request and 22 days for the second. By not responding to other states' requests for case status reviews within the required five days, DCSS may be unnecessarily delaying the other states from enforcing support orders and collecting child support.

RECOMMENDATIONS

DCSS should take steps to ensure that it responds to all requests for case status reviews from other states within five working days of receiving the requests. In addition, DCSS should indicate on each request the date DCSS received it.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

It has always been the policy in the California Central Registry (CCR) to date-stamp all incoming mail, including status requests from other states. However, as discussed with staff from the Bureau of State Audits (BSA), an oversight occurred at the CCR during the audit period, which resulted in incoming status requests not being date-stamped. Immediately after the BSA's review of the CCR in June 2004, the staff was instructed to resume date-stamping all income status requests and made aware of the importance of following this procedure, so that this oversight does not occur again. The CCR is now following the correct procedures and date-stamping all incoming mail, including status requests, on the date of receipt.

Reference Number: 2004-14-2

Federal Catalog Number: 93.959

Federal Program Title:	Block Grants for Prevention and Treatment of Substance Abuse
Federal Award Number and Calendar Year Awarded:	04B1CASAPT; 2003
Category of Finding:	Special Tests and Provisions
State Administering Department:	Department of Alcohol and Drug Programs

CRITERIA

Our review of the Block Grants for Prevention and Treatment of Substance Abuse program identified the following requirement related to special tests and provisions:

The Code of Federal Regulations, Title 45, Section 96.136, requires the State to provide for independent peer reviews of at least 5 percent of the treatment providers receiving funds to assess the quality, appropriateness, and efficacy of treatment services provided to individuals.

CONDITION

The Department of Alcohol and Drug Programs (DADP) did not ensure that independent peer reviews were conducted for at least 5 percent of the treatment providers receiving funds from the Block Grants for Prevention and Treatment of Substance Abuse program. In the past DADP contracted with an outside party to conduct independent peer reviews. However, as indicated in its fiscal year 2004–05 grant application, DADP did not have a contract in place during fiscal year 2003–04 because it believed that states would no longer be required to conduct independent peer reviews. As a result, none of the 678 treatment providers receiving funds from the Block Grants for Prevention and Treatment of Substance Abuse program during fiscal year 2003–04 received a peer review. DADP plans to resume the independent peer reviews of treatment providers in fiscal year 2004–05 and has awarded a contract to conduct independent peer reviews of 32 to 35 treatment providers.

RECOMMENDATION

DADP should ensure annually that at least 5 percent of treatment providers receiving funds from the Block Grants for Prevention and Treatment of Substance Abuse program receive an independent peer review.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

The DADP concurs with the assessment of the Federal compliance review; peer reviews were not conducted for Fiscal Year 2003–04.

The DADP initiated the independent peer review contract with the California Association of Addiction Recovery Resources (CAARR) for Fiscal Year 2004–05 (renewable for two additional fiscal years), and has appointed a contract monitor to ensure the peer reviews are conducted in accordance with Federal requirements and timeframes. CAARR will conduct 32 to 35 peer reviews each fiscal year upon approval of the Substance Abuse Prevention and Treatment Block Grant. The Department will ensure that a minimum of 5 percent of treatment providers receiving funds from the Block Grants for Prevention and Treatment of Substance Abuse program receives an independent peer review.

Reference Number:	2004-14-5
Federal Catalog Number:	93.778
Federal Program Title:	Medical Assistance Program
Federal Award Numbers and Calendar Years Awarded:	05-0305CA5028; 2002 05-0405CA5028; 2003
Category of Finding:	Special Tests and Provisions
State Administering Department:	Department of Health Services

CRITERIA

Our review of the Medical Assistance Program (Medicaid) identified the following compliance requirements related to special tests and provisions:

The Code of Federal Regulations, Title 42, sections 431.51(b) and (c), allows recipients to obtain Medicaid services from any provider qualified and willing to furnish the services. However, these regulations do not prohibit the state Medicaid agency from setting reasonable standards for provider qualifications. For example, the California Welfare and Institutions Code, Section 14043.6, requires automatic suspension from the state Medicaid program for any provider whose license, certificate, or other approval has been revoked or suspended by a federal, California, or another state's licensing, certification, or approval authority, or has been surrendered or otherwise lost while a disciplinary hearing was pending.

Additionally, the Code of Federal Regulations, Title 42, Section 442.101, requires that certain Medicaid facility providers obtain certification before a Medicaid agency enters a provider agreement with the provider. Furthermore, sections 455.104 through 455.106 require Medicaid providers and facilities to make certain disclosures to the State regarding ownership, business transactions, and criminal convictions. Finally, Title 42, Section 431.107, also requires the State to provide for an agreement between each provider and the state agency administering the Medicaid program. Among other things, the provider must agree to disclose the information required in sections 455.104 through 455.106.

CONDITION

Our review of selected Medicaid providers revealed that the Department of Health Services (Health Services) did not always have the required agreements, disclosures, licenses and certifications on file.

Of the 30 providers we reviewed, Health Services did not have provider agreements on file for 14 providers, did not have any of the required disclosures on file for five providers, and did not obtain the required license and certification for one provider. In response to a similar finding in our fiscal year 2002–03 audit report, Health Services indicated it has begun a reenrollment process that includes gathering appropriate licenses, certifications, agreements, and disclosures. According to Health Services, it is prioritizing provider types for the new reenrollment process based on the provider types with the highest risk. Health Services also indicated that it targeted durable medical equipment providers as the first group for reenrollment and has completed reenrollment for this provider type. Health Services has been working to reenroll pharmacy providers for more than a year and has also begun reenrollment of physician providers.

When Health Services cannot demonstrate that it has obtained provider certifications, licenses, proper agreements, and disclosures, it cannot ensure that it made Medicaid claim payments only to eligible providers.

RECOMMENDATION

Health Services should continue its reenrollment process to ensure that it obtains the appropriate licenses, certifications, agreements, and disclosures.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Health Services agrees and is continuing its reenrollment process. Provider Enrollment Branch (PEB) is pursuing, with other departments/entities enrolling Medi-Cal providers, the need to comply with this requirement. PEB's newly modified Medi-Cal Disclosure Statement (DHS 6207) form was prepared and designed to specifically comply with Code of Federal Regulations governing information that must be disclosed by providers for participation or continued participation in the Medi-Cal program. In addition to the form's compliance with federal regulations, the comprehensive modification enables the disclosure form to be used by other departmental programs and other entities involved in the enrollment process. This form is currently available on-line at www.medi-cal.ca.gov.

In order to meet this requirement, Health Services' Deputy Director of Medi-Cal Services has prepared a letter to all Medi-Cal linked departments, which addresses provider enrollment and specifically, the federal disclosure regulatory requirements. The letter includes the Centers for Medicare and Medicaid Services finding, description of required information, and a copy of the DHS 6207. The departments will be asked to bring disclosure information into compliance prior to the completion of an amended interagency agreement requiring such compliance. Health Services distributed the letter in February 2005.

Health Services is fully committed to reenrolling all providers on a continuing basis in accordance with all federal and state statutes and regulations. PEB and Audits and Investigations (A&I) have a coordinated effort to implement this strategy on a provider type basis. Reenrollment of durable medical equipment providers has been completed and Health Services is currently concentrating on non-chain pharmacies and physicians/groups identified by A&I as high-risk providers. To achieve maximum effectiveness, PEB and A&I will continue to coordinate efforts to identify providers posing the greatest risk to the Medi-Cal program. Once Health Services completes reenrollment of these high-risk providers, the process will be continued for all other providers on an ongoing basis. It should be noted that with over 100,000 providers enrolled in Medi-Cal, reenrollment of all providers will require significant resources and time intensive processes. To date, approximately 2,300 providers (pharmacies and physicians) are going through the reenrollment process.

U.S. DEPARTMENT OF HOMELAND SECURITY

Reference Number:	2004-9-5
Federal Catalog Number:	97.036 (formerly 83.544)
Federal Program Title:	Public Assistance Grants
Year Awarded:	State fiscal year 2003–04
Category of Finding:	Suspension and Debarment
State Administering Department:	Office of Emergency Services

CRITERIA

Our review of the Public Assistance Grants program identified the following compliance requirements related to suspension and debarment:

The Code of Federal Regulations, Title 44, Section 17.225(a), requires the Office of Emergency Services (Emergency Services) to ensure that it does not make subawards to any parties who are debarred, suspended, or otherwise excluded from participation in federal assistance programs. Additionally, Section 17.510(b) requires Emergency Services to obtain certifications that affirm participating parties are not presently debarred or suspended.

CONDITION

Emergency Services did not require applicants to the Public Assistance Grants program to submit suspension and debarment certifications. By not requiring these certifications, Emergency Services risks allowing suspended or debarred parties to participate in the federal program. However, we tested a sample of 35 subrecipients using alternative procedures and determined that none of the subrecipients in our sample were suspended or debarred.

RECOMMENDATION

Emergency Services should revise its application for the Public Assistance Grants program to include suspension and debarment certifications.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Previously, Emergency Services agreed to modify its standard assurance form for the Public Assistance Grants program to specifically address the suspension and debarment requirements noted in the Code of Federal Regulations. Emergency Services also agreed to implement the new form for future disaster grants.

Unfortunately, Emergency Services did not implement those form changes. During the past 12 months, Emergency Services has experienced a decrease in staffing levels, the mid-year assimilation of the former Office of Criminal Justice Planning, and a steadily increasing workload related to Homeland Security grants. Additionally, Emergency Services recently reorganized and is in the process of evaluating priorities, workloads and staffing. The revision of existing forms will be included in the workload evaluation process.

Reference Number:	2004-12-3
Federal Catalog Number:	97.036 (formerly 83.544)
Federal Program Title:	Public Assistance Grants
Year Awarded:	State fiscal year 2003–04
Category of Finding:	Reporting
State Administering Department:	Office of Emergency Services

CRITERIA

Our review of the Public Assistance Grants program identified the following compliance requirement related to reporting:

The Code of Federal Regulations, Title 44, Section 206.204(f), requires the Office of Emergency Services (Emergency Services) to submit quarterly progress reports to the Federal Emergency Management Agency (FEMA), part of the U.S. Department of Homeland Security.

CONDITION

Emergency Services reported incorrect financial information in its June 2004 quarterly progress report. Specifically, for three of the 20 projects we reviewed, Emergency Services understated the project obligations by a total of more than $200 million. Additionally, we could not determine whether the total amounts reported for two additional projects were correct because Emergency Services used incorrect project numbers in its quarterly progress report. Emergency Services reported obligations for the two projects of $80 million and $250,000, respectively. According to Emergency Services, a field office provided the total obligations for the five projects, and staff at Emergency Services' headquarters did not review the amounts for accuracy before they were reported to FEMA.

RECOMMENDATION

Emergency Services should ensure that its staff review the accuracy of the financial information contained in each quarterly progress report.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Emergency Services recognizes this finding and is developing a procedure to address the finding. The Public Assistance Section has been made aware of the requirement to include accurate project cost information in the quarterly progress reports to FEMA. All subsequent Quarterly Reports will include an attachment generated by Emergency Services' Grant Management Section from the Automated Ledger System with the latest required cost data for all projects for which final payment has not been made for all open disaster declarations. To avoid reporting conflicts between the two Emergency Services' sections, all cost data will be removed from the Large Project Monitoring Program reports generated by the Public Assistance Section staff. In addition, all future revisions of the State Administrative Plan for Public Assistance will include the stipulation that the quarterly progress reports to FEMA will include, for each open project, the obligated amount, the amount claimed by the subgrantee, the paid amount and the balance of obligated funding.

Reference Number:	2004-12-4
Category of Finding:	Reporting
State Administering Department:	Office of Emergency Services

(See listing of the specific federal program details following the discussion of the issues below.)

CRITERIA

Our review of the Public Assistance Grants and Hazard Mitigation Grant programs determined the following compliance requirements related to reporting:

The Code of Federal Regulations, Title 44, Section 13.20, requires the Office of Emergency Services (Emergency Services) to maintain accounting records to properly track and accurately report financial activities related to federal grants. Additionally, Section 13.41(b) requires Emergency Services to use the financial status report form to report on the status of federal funds for nonconstruction grants. To meet this requirement, the Federal Emergency Management Agency (FEMA), an agency within the U.S. Department of Homeland Security, requires Emergency Services to submit quarterly financial status reports for each disaster. FEMA mandates that these status reports include total recipient and subrecipient nonfederal expenditures and administrative expenses.

CONDITION

Emergency Services' financial status reports do not always contain complete expenditure information. Specifically, for 16 of the 18 financial status reports for fiscal year 2003–04 that we tested, Emergency Services did not report the subrecipients' shares of outlays for the Hazard Mitigation Grant program because it does not have a process to consistently capture the expenditure information it receives from subrecipients. Also, Emergency Services did not provide separate disclosure of its and the subrecipients' administrative costs in the financial status reports for the Public Assistance Grants and Hazard Mitigation Grant programs. FEMA requires separate reporting of administrative expenditures so that it can accurately compute and analyze the shared costs of the disaster.

RECOMMENDATIONS

Emergency Services should record subrecipients' shares of Hazard Mitigation Grant program outlays it receives and accurately report those expenditures. Additionally, Emergency Services should separately account for and report its and the subrecipients' administrative costs in accordance with FEMA instructions.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Emergency Services has made several attempts over the years to discuss with the Federal Emergency Management Agency (FEMA) how best to report California disaster activity (which involves more than 20,000 individual projects) into a single generic format. Although Emergency Services has informally discussed the issue with FEMA staff, given the repeat nature of this finding, Emergency Services will initiate a formal request to FEMA management this year to reach a consensus on how to report on-going disaster activity without creating a burdensome workload for the state.

U.S DEPARTMENT OF HOMELAND SECURITY

Federal Catalog Number:	97.036 (formerly 83.544)
Federal Program Title:	Public Assistance Grants
Year Awarded:	State fiscal year 2003–04

Federal Catalog Number:	97.039 (formerly 83.548)
Federal Program Title:	Hazard Mitigation Grant
Year Awarded:	State fiscal year 2003-04

Reference Number:	2004-13-8
Federal Catalog Number:	97.036 (formerly 83.544)
Federal Program Title:	Public Assistance Grants
Year Awarded:	State fiscal year 2003–04

Category of Finding: Subrecipient Monitoring

State Administering Department: Office of Emergency Services

CRITERIA

Our review of the Public Assistance Grants program identified the following compliance requirements related to subrecipient monitoring:

The Code of Federal Regulations, Title 44, Section 13.40(a), requires the Office of Emergency Services (Emergency Services) to monitor grant- and subgrant-supported activities to ensure that applicable federal requirements are being complied with and that performance goals are being achieved. Further, the State Administrative Plan for Public Assistance (administrative plan)—the state plan approved by the Federal Emergency Management Agency (FEMA)—an agency within the U.S. Department of Homeland Security—specifies that a selected number of larger projects and projects with extenuating considerations will be monitored at least on a quarterly basis to ensure compliance with grant requirements as a whole.

To meet the requirements of the Code of Federal Regulations and the administrative plan, Emergency Services developed the Large Project Monitoring Program (monitoring program). Projects are included in the monitoring program if they meet minimum dollar thresholds or certain risk criteria. To facilitate project monitoring, Emergency Services staff are required to prepare Quarterly Construction Performance Reports (quarterly reports) for projects included in the monitoring program using data collected from subrecipients.

CONDITION

Emergency Services did not adequately monitor subrecipients of federal funds from the Public Assistance Grants program. Specifically, for 13 of the 15 projects included in its monitoring program, Emergency Services did not complete one or more quarterly reports. According to Emergency Services, some of the reports are missing because staff often had difficulty obtaining project information from subrecipients. Emergency Services uses the quarterly reports to identify potential problems with the grants, such as cost overruns, deviations from the eligible scope of work, and whether a project will not be completed on time. Because Emergency Services was unable to complete many of the reports, it has less assurance that the subrecipients are using grant funds as intended or that the projects are progressing as planned.

RECOMMENDATIONS

To ensure that it adequately monitors subrecipients of the Public Assistance Grants program, Emergency Services should implement measures to compel subrecipients to provide project information for the quarterly reports in a timely manner. When it is unsuccessful in obtaining the information it needs from subrecipients, it should employ alternative monitoring techniques.

DEPARTMENT'S VIEW AND CORRECTIVE ACTION PLAN

Emergency Services recognizes this finding and is in the process of developing a system to automate the subgrantee quarterly progress reporting process. Until the new system is fully implemented, the Public Assistance Grants section is making every effort to collect the information needed from subgrantees to complete the Quarterly Construction Performance Reports for all projects included in the large project monitoring program and include this information in the quarterly progress reports to FEMA. The Public Assistance Grants staff have been instructed to notify Emergency Services management of any nonconforming applicants so arrangements can be made to withhold funding for these applicants until they comply with the quarterly reporting requirements.

AUDITEE'S SECTION

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Schedule of Federal Assistance

Prepared by
Department of Finance

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STATE OF CALIFORNIA
SCHEDULE OF FEDERAL ASSISTANCE
FISCAL YEAR ENDED JUNE 30, 2004

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received	
Department of Agriculture			
Plant and Animal Disease, Pest Control, and Animal Care	10.025	$ 82,612	
Market Protection and Promotion	10.163	462,006	
Farm Labor Housing Loans and Grants	10.405	5,799,324	
Food Distribution	10.550	100,841,633	*
Special Supplemental Nutrition Program for Women, Infants, and Children	10.557	843,264,550	
Child and Adult Care Food Program	10.558	233,360,020	
State Administrative Expenses for Child Nutrition	10.560	15,260,513	
Commodity Supplemental Food Program	10.565	3,024,511	
Nutrition Services Incentive	10.570	1,772,759	
WIC Farmers' Market Nutrition Program (FMNP)	10.572	3,237,523	
Team Nutrition Grants	10.574	195,736	
Cooperative Forestry Assistance	10.664	7,134,261	
National Forest - Dependent Rural Communities	10.670	152,268	
Wildlife Habitat Incentive Program	10.914	205	
Other - U.S. Department of Agriculture	10.999	38,634,230	
Total Excluding Clusters		1,253,222,151	
Food Stamp Cluster			
Food Stamps	10.551	1,903,216,237	*
State Administrative Matching Grants for Food Stamp Program	10.561	377,079,163	
Total Food Stamp Cluster		2,280,295,400	
Child Nutrition Cluster			
School Breakfast Program	10.553	224,093,865	
National School Lunch Program	10.555	875,559,291	
Special Milk Program for Children	10.556	642,294	
Summer Food Service Program for Children	10.559	15,528,178	
Total Child Nutrition Cluster		1,115,823,628	

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received	
Emergency Food Assistance Cluster			
Emergency Food Assistance Program (Administrative Costs)	10.568	10,653,508	
Emergency Food Assistance Program (Food Commodities)	10.569	48,539,038	*
Total Emergency Food Assistance Cluster		59,192,546	
Schools and Roads Cluster			
Schools and Roads - Grants to States	10.665	62,077,565	
Research and Development Cluster			
Agricultural Research Service - Basic and Applied Research	10.001	9,500	
Plant and Animal Disease, Pest Control, and Animal Care	10.025	115,390	
Total Research and Development Cluster		124,890	
Total U.S. Department of Agriculture		4,770,736,180	
Department of Commerce			
Economic Development - Support for Planning Organizations	11.302	100,000	
Anadromous Fish Conservation Act Program	11.405	789,081	
Interjurisdictional Fisheries Act of 1986	11.407	159,587	
Coastal Zone Management Administration Awards	11.419	5,396,520	
Coastal Zone Management Estuarine Research Reserves	11.420	786,247	
Marine Sanctuary Program	11.429	12,170	
Pacific Coast Salmon Recovery - Pacific Salmon Treaty Program	11.438	19,025,601	
Habitat Conservation	11.463	265,663	
Fisheries Disaster Relief	11.477	457,007	
Other - U.S. Department of Commerce	11.999	95,623	
Total U.S. Department of Commerce		27,087,499	

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received	
Department of Defense			
Navigation Projects	12.107	71,283	
Planning Assistance to States	12.110	1,389,342	
State Memorandum of Agreement Program for the Reimbursement of Technical Services	12.113	12,862,870	
National Guard Military Operations and Maintenance (O&M) Projects	12.401	49,012,151	
National Guard Civilian Youth Opportunities	12.404	5,072,795	
Other - U.S. Department of Defense	12.999	1,381,222	
Total U.S. Department of Defense		69,789,663	
Department of Housing and Urban Development			
Manufactured Home Construction and Safety Standards	14.171	202,571	
Community Development Block Grants/State's Program	14.228	47,317,981	
Emergency Shelter Grants Program	14.231	5,724,767	
Supportive Housing Program	14.235	4,989,427	***
HOME Investment Partnerships Program	14.239	96,197,699	***
Housing Opportunities for Persons with AIDS	14.241	2,309,531	
Equal Opportunity in Housing	14.400	3,150,884	
Section 8 Rental Voucher Program	14.855	3,360,058	
Lead-Based Paint Hazard Control Privately-Owned Housing	14.900	964,470	
Total Excluding Clusters		164,217,388	
Section 8 Project-Based Cluster			
Lower Income Housing Assistance Program - Section 8 Moderate Rehabilitation	14.856	38,066	
Total U.S. Department of Housing and Urban Development		164,255,454	

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Department of the Interior		
Recreation Resource Management	15.225	7,279
Wildland Urban Interface Community and Rural Fire Assistance	15.228	886,725
Small Reclamation Projects	15.503	323,341
Water Reclamation and Reuse Program	15.504	19,302
Anadromous Fish Conservation	15.600	19,385
Fish and Wildlife Management Assistance	15.608	16,267
Endangered Species Conservation	15.612	382,268
Coastal Wetlands Planning, Protection and Restoration Act	15.614	1,290,533
Cooperative Endangered Species Conservation Fund	15.615	1,699,052
Clean Vessel Act	15.616	603,000
Wildlife Conservation and Appreciation	15.617	20,000
Sportfishing and Boating Safety Act	15.622	290,000
Wildlife Conservation and Restoration	15.625	1,619,553
U.S. Geological Survey - Research and Data Acquisition	15.808	456,207
Historic Preservation Fund Grants-In-Aid	15.904	1,169,026
Outdoor Recreation-Acquisition, Development and Planning	15.916	5,251,507
Native American Graves Protection and Repatriation Act	15.922	3,943
Research Information	15.975	985,997
Other - U.S. Department of the Interior	15.999	35,837,841
Total Excluding Clusters		50,881,226
Fish and Wildlife Cluster		
Sport Fish Restoration	15.605	9,077,637
Wildlife Restoration	15.611	4,676,471
Total Fish and Wildlife Cluster		13,754,108
Research and Development Cluster		
Anadromous Fish Conservation	15.600	57,746
Coastal Wetlands Planning, Protection and Restoration Act	15.614	23,121
Cooperative Endangered Species Conservation Fund	15.615	4,820
Total Research and Development Cluster		85,687
Total U.S. Department of Interior		64,721,021

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Department of Justice		
State Domestic Preparedness Equipment Support Program	16.007	54,496,449
Offender Reentry Program	16.202	72,926
Juvenile Accountability Incentive Block Grants	16.523	42,458,628
Juvenile Justice and Delinquency Prevention - Allocation to States	16.540	5,915,637
Juvenile Justice and Delinquency Prevention - Special Emphasis	16.541	2,403,353
Title V - Delinquency Prevention Program	16.548	24,986
Part E - State Challenge Activities	16.549	602,558
State Justice Statistics Program for Statistical Analysis Centers	16.550	30,115
National Criminal History Improvement Program (NCHIP)	16.554	2,699,399
National Institute of Justice Research, Evaluation, and Development Project Grants	16.560	187,614
Crime Victim Assistance	16.575	44,722,534
Crime Victim Compensation	16.576	1,564,977
Byrne Formula Grant Program	16.579	31,303,007
Drug Court Discretionary Grant Program	16.585	168,812
Violent Offender Incarceration and Truth in Sentencing Incentive Grants	16.586	55,777,477
Violence Against Women Formula Grants	16.588	12,625,234
Rural Domestic Violence and Child Victimization Enforcement Grant Program	16.589	55,183
Residential Substance Abuse Treatment for State Prisoners	16.593	3,311,106
State Criminal Alien Assistance Program	16.606	66,182,010
Regional Information Sharing Systems	16.610	4,453,942
Public Safety Partnership and Community Policing Grants	16.710	4,247,493
National Incident Based Reporting System	16.733	467,224
Other - U.S. Department of Justice	16.999	968,934
Total U.S. Department of Justice		334,739,598

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Department of Labor		
Labor Force Statistics	17.002	7,394,776
Compensation and Working Conditions Data	17.005	704,836
Labor Certification for Alien Workers	17.203	4,675,768
Unemployment Insurance	17.225	7,066,336,721
Senior Community Service Employment Program	17.235	6,611,761
Trade Adjustment Assistance-Workers	17.245	23,185,973
Employment Services and Job Training - Pilot and Demonstration Programs	17.249	55,633
Welfare-to-Work Grants to States and Localities	17.253	25,887,053
Workforce Investment Act	17.255	12,501,521
Employment and Training Administration Pilots, Demonstrations, and Research Projects	17.261	504,893
Work Incentives Grant	17.266	437,045
Occupational Safety and Health - State Program	17.503	23,716,100
Consultation Agreements	17.504	5,083,396
Mine Health and Safety Grants	17.600	425,801
Employment Programs for People with Disabilities	17.720	16,199
Veterans' Employment Program	17.802	832,707
Other - U.S. Department of Labor	17.999	407,614
Total Excluding Clusters		7,178,777,797
Employment Services Cluster		
Employment Service	17.207	99,376,805
Disabled Veterans' Outreach Program (DVOP)	17.801	9,065,172
Local Veterans' Employment Representative Program	17.804	6,897,623
Total Employment Services Cluster		115,339,600
WIA Cluster		
WIA Adult Program	17.258	166,624,300
WIA Youth Activities	17.259	168,634,744
WIA Dislocated Workers	17.260	209,031,654
Total WIA Cluster		544,290,698
Total U.S. Department of Labor		7,838,408,095

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received	
Department of Transportation			
Boating Safety Financial Assistance	20.005	3,583,437	
Airport Improvement Program	20.106	125,719	
Motor Carrier Safety	20.217	10,512,097	
Local Rail Freight Assistance	20.308	914,266	
High Speed Ground Transportation - Next Generation High Speed Rail Program	20.312	384,539	
Federal Transit - Metropolitan Planning Grants	20.505	41,455,279	
Formula Grants for Other Than Urbanized Areas	20.509	16,894,781	
Pipeline Safety	20.700	1,811,309	
Interagency Hazardous Materials Public Sector Training and Planning Grants	20.703	716,287	
Total Excluding Clusters		76,397,714	
Highway Planning and Construction Cluster			
Highway Planning and Construction	20.205	2,085,876,257	***
Federal Transit Cluster			
Federal Transit - Capital Investment Grants	20.500	9,226,853	
Highway Safety Cluster			
State and Community Highway Safety	20.600	61,720,914	
Research and Development Cluster			
Highway Planning and Construction	20.205	13,554,895	
National Motor Carrier Safety	20.218	91,579	
Formula Grants for Other Than Urbanized Areas	20.509	145,107	
State Planning and Research	20.515	1,940,124	
Total Research and Development Cluster		15,731,705	
Total U.S. Department of Transportation		2,248,953,443	
Department of the Treasury			
Temporary State Fiscal Relief	21.999	575,906,288	

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received	
Equal Employment Opportunity Commission			
Employment Discrimination - State and Local Fair Employment Practices Agency Contracts	30.002	3,109,200	
General Services Administration			
Donation of Federal Surplus Personal Property	39.003	5,652,161	**
Election Reform Payments	39.011	84,663,537	
Other - General Services Administration	39.999	94,559,169	
Total General Services Administration		184,874,867	
National Aeronautics and Space Administration			
Technology Transfer	43.002	209,163	
National Foundation on the Arts and the Humanities			
Promotion of the Arts - State and Regional Program	45.007	962,600	
State Library Program	45.310	16,990,723	
Total National Foundation on the Arts and Humanities		17,953,323	
Small Business Administration			
Small Business Development Center	59.037	1,622,269	
Department of Veterans Affairs			
Veterans State Domiciliary Care	64.014	9,041,948	
Veterans State Nursing Home Care	64.015	10,738,594	
Veterans State Hospital Care	64.016	105,680	
Veterans Housing - Guaranteed and Insured Loans	64.114	238,407,041	***

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
All Volunteer Force Educational Assistance	64.124	71,774
Other - U.S. Department of Veterans Affairs	64.999	1,280,096
Total U.S. Department of Veteran's Affairs		259,645,133
Environmental Protection Agency		
Air Pollution Control Program Support	66.001	9,502,076
State Indoor Radon Grants	66.032	125,000
Water Pollution Control State and Interstate Program Support	66.419	6,615,433
State Underground Water Source Protection	66.433	471,895
Water Quality Management Planning	66.454	850,367
National Estuary Program	66.456	275,179
Capitalization Grants for Clean Water State Revolving Funds	66.458	36,605,544
Nonpoint Source Implementation Grants	66.460	11,658,237
Wetland Program Development Grants	66.461	343,616
Water Quality Cooperative Agreements	66.463	732,370
Capitalization Grants for Drinking Water State Revolving Fund	66.468	57,931,074
Hardship Grants Program for Rural Communities	66.470	25,000
Beach Monitoring and Notification Program Development Grants	66.472	484,830
Environmental Protection - Consolidated Research	66.500	102,828
Safe Drinking Water Research and Demonstration	66.506	8,716,618
Surveys, Studies, Investigations and Special Purpose Grants	66.606	1,080,888
State Information Grants	66.608	88,950
Consolidated Pesticide Enforcement Cooperative Agreements	66.700	1,412,001
Toxic Substances Compliance Monitoring Cooperative Agreements	66.701	53,134
TSCA Title IV State Lead Grants Certification of Lead-Based Paint Professionals	66.707	569,815
Pollution Prevention Grants Program	66.708	63,313
Hazardous Waste Management State Program Support	66.801	7,813,957
Superfund State, Political Subdivision, and Indian Tribe Site-Specific Cooperative Agreements	66.802	1,639,802

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
State and Tribal Underground Storage Tanks Program	66.804	325,793
Leaking Underground Storage Tank Trust Fund Program	66.805	2,915,462
Solid Waste Management Assistance	66.808	32,380
Superfund State and Indian Tribe Core Program Cooperative Agreements	66.809	127,132
State and Tribal Response Program Grants	66.817	792,888
U.S.-Mexico Border Grants Program	66.930	137,219
Total Excluding Clusters		151,492,801
Research and Development Cluster		
Wetland Program Development Grants	66.461	2,075
Consolidated Pesticide Enforcement Cooperative Agreements	66.700	25,710
Pollution Prevention Grants Program	66.708	223,557
Pesticide Environmental Stewardship - Regional Grants	66.714	5,700
Total Research and Development Cluster		257,042
Total U.S. Environmental Protection Agency		151,749,843
Office of State and Tribal Programs, Nuclear Regulatory Commission		
Radiation Control - Training Assistance and Advisory Counseling	77.001	39,707
Department of Energy		
State Energy Program	81.041	2,860,002
Weatherization Assistance for Low-Income Persons	81.042	6,770,680
Environmental Restoration	81.092	461,096
National Industrial Competitiveness through Energy, Environment, and Economics	81.105	18,160
Other - U.S. Department of Energy	81.999	473,646
Total U.S. Department of Energy		10,583,584

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Federal Emergency Management Agency		
Community Assistance Program - State Support Services Element (CAP-SSSE)	83.105	534,646
Earthquake Hazards Reduction Grants	83.521	30,918
Flood Mitigation Assistance	83.536	915,792
Public Assistance Grants	83.544	151,713,513
Hazard Mitigation Grant	83.548	39,620,407
Emergency Management Performance Grants	83.552	8,210,167
Fire Management Assistance Grant	83.556	4,689,353
Pre-Disaster Mitigation	83.557	632,214
State and Local All Hazards Emergency Operations Planning	83.562	8,144,736
Emergency Operations Centers	83.563	9,532
Citizen Corps	83.564	1,772,723
Other - Federal Emergency Management Agency	83.999	127,412
Total Federal Emergency Management Agency		216,401,413
Department of Education		
Adult Education - State Grant Program	84.002	86,857,168
Title I Grants to Local Educational Agencies	84.010	1,310,013,936
Migrant Education - State Grant Program	84.011	125,340,772
Title I Program for Neglected and Delinquent Children	84.013	1,862,519
Vocational Education - Basic Grants to States	84.048	132,661,367
Vocational Education - State Councils	84.053	394,537
Leveraging Educational Assistance Partnership	84.069	11,668,907
Rehabilitation Services - Vocational Rehabilitation Grants to States	84.126	244,483,419
Rehabilitation Services - Service Projects	84.128	1,272,840
Public Library Construction and Technology Enhancement	84.154	120,973
Independent Living-State Grants	84.169	1,831,127
Rehabilitation Services - Independent Living Services for Older Individuals Who are Blind	84.177	2,719,663
Special Education - Grants for Infants and Families with Disabilities	84.181	51,158,138
Safe and Drug-Free Schools and Communities - National Programs	84.184	1,827,225
Byrd Honors Scholarships	84.185	5,686,000

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Safe and Drug-Free Schools and Communities - State Grants	84.186	51,415,539
Supported Employment Services for Individuals with Severe Disabilities	84.187	3,949,853
Education for Homeless Children and Youth	84.196	7,404,637
Even Start - State Educational Agencies	84.213	32,895,674
Fund for the Improvement of Education	84.215	41,966
Assistive Technology	84.224	800,853
Tech-Prep Education	84.243	14,227,773
Rehabilitation Training - State Vocational Rehabilitation Unit In-Service Training	84.265	355,140
Goals 2000 - State and Local Education Systematic Improvement Grants	84.276	79,796
School to Work Opportunities	84.278	2,896,638
Eisenhower Professional Development State Grants	84.281	14,303,830
Charter Schools	84.282	23,476,264
Twenty-First Century Community Learning Centers	84.287	33,069,442
Foreign Language Assistance	84.293	51,223
State Grants for Innovative Programs	84.298	42,930,551
Even Start - Statewide Family Literacy Program	84.314	104,712
Education Technology State Grants	84.318	96,982,261
Special Education - State Program Improvement Grants for Children with Disabilities	84.323	2,981,254
Advanced Placement Program	84.330	3,224,462
Grants to States for Incarcerated Youth Offenders	84.331	1,959,061
Comprehensive School Reform Demonstration	84.332	34,294,849
Child Care Access Means Parents in School	84.335	13,748
Teacher Quality Enhancement Grants	84.336	1,903,359
Reading Excellence	84.338	4,808,743
Class Size Reduction	84.340	3,003,414
Preparing Tomorrow's Teachers to Use Technology	84.342	59,181
Title I Accountability Grants	84.348	11,791,135
Transition to Teaching	84.350	378,743
School Renovation Grants	84.352	70,040,037
Reading First State Grants	84.357	87,267,214
Rural Education	84.358	2,598,464
Literacy Through School Libraries	84.364	40,342
English Language Acquisition Grants	84.365	109,352,433

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received	
Mathematics and Science Partnerships	84.366	5,421	
Improving Teacher Quality State Grants	84.367	260,511,181	
Grants for State Assessments and Related Activities	84.369	14,037,094	
Total Excluding Clusters		2,911,154,878	
Student Financial Aid Cluster			
Federal Family Education Loans	84.032	22,423,957,743	***
Special Education Cluster			
Special Education - Grants to States	84.027	969,676,627	
Special Education - Preschool Grants	84.173	38,706,252	
Total Special Education Cluster		1,008,382,879	
Total U.S. Department of Education		26,343,495,500	
Consumer Product Safety Commission			
Other - Consumer Product Safety Commission	87.999	6,150	
Department of Health and Human Services			
Public Health and Social Services Emergency Fund	93.003	6,749,951	
Special Programs for the Aging - Title VII, Chapter 3, Programs for Prevention of Elder Abuse, Neglect, and Exploitation	93.041	512,757	
Special Programs for the Aging - Title VII, Chapter 2 - Long Term Ombudsman Services for Older Individuals	93.042	1,529,468	
Special Programs for the Aging - Title III, Disease Part D - Prevention and Health Promotion Services	93.043	2,687,649	
Special Programs for the Aging - Title IV - and Title II - Discretionary Projects	93.048	333,812	
National Family Caregiver Support	93.052	15,670,875	
Food and Drug Administration - Research	93.103	1,136,637	
Maternal and Child Health Federal Consolidated Programs	93.110	105,084	
Biological Response to Environmental Health Hazards	93.113	30,449	
Project Grants and Cooperative Agreements for Tuberculosis Control Programs	93.116	8,552,420	

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Emergency Medical Services for Children	93.127	97,254
Primary Care Services - Resource Coordination and Development	93.130	192,949
Injury Prevention and Control Research and State and Community Based Programs	93.136	17,096,802
Projects for Assistance in Transition from Homelessness	93.150	5,937,103
Health Program for Toxic Substances and Disease Registry	93.161	1,022,675
Grants for State Loan Repayment	93.165	654,183
Disabilities Prevention	93.184	216,162
Consolidated Knowledge Development and Application (KD&A) Program	93.230	1,410,805
Cooperative Agreements for State Treatment Outcomes and Performance Pilot Studies Enhancement	93.238	75,462
Policy Research and Evaluation Grants	93.239	189,535
State Rural Hospital Flexibility Program	93.241	407,400
Substance Abuse and Mental Health Services - Projects of Regional and National Significance	93.243	457,016
Universal Newborn Hearing Screening	93.251	26,531
Rural Access to Emergency Devices Grant	93.259	197,972
Immunization Grants	93.268	182,166,907
Centers for Disease Control and Prevention - Investigations and Technical Assistance	93.283	60,157,312
Promoting Safe and Stable Families	93.556	51,176,114
Temporary Assistance for Needy Families	93.558	3,094,459,687
Child Support Enforcement	93.563	437,595,741
Child Support Enforcement Research	93.564	11,438
Refugee and Entrant Assistance - State Administered Programs	93.566	25,520,821
Low-Income Home Energy Assistance	93.568	99,997,480
Community Services Block Grant	93.569	63,812,232
Community Services Block Grant Discretionary Awards - Community Food and Nutrition	93.571	557,059
Refugee and Entrant Assistance - Discretionary Grants	93.576	4,959,635
U.S. Repatriation Program	93.579	42,994
Refugee and Entrant Assistance - Targeted Assistance Grants	93.584	5,918,931
Empowerment Zones Program	93.585	343,899
State Court Improvement Program	93.586	988,822
Community-Based Family Resource and Support Grants	93.590	2,587,956

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Welfare Report Research, Evaluations, and National Studies	93.595	108,309
Grants to States for Access and Visitation Programs	93.597	1,139,048
Head Start	93.600	165,957
Adoption Incentive Payments	93.603	5,079,102
Developmental Disabilities Basic Support and Advocacy Grants	93.630	7,814,035
Children's Justice Grants to States	93.643	918,931
Child Welfare Services - State Grants	93.645	41,100,948
Social Services Research and Demonstration	93.647	226,959
Adoption Opportunities	93.652	259,858
Foster Care - Title IV-E	93.658	1,182,419,351
Adoption Assistance	93.659	246,550,251
Social Services Block Grant	93.667	319,680,600
Child Abuse and Neglect State Grants	93.669	1,020,670
Family Violence Prevention and Services/Grants for Battered Women's Shelters-Grants to States and Indian Tribes	93.671	1,101,569
Chafee Foster Care Independent Living	93.674	26,859,901
State Children's Insurance Program	93.767	651,665,396
Medicaid Infrastructure Grants To Support the Competitive Employment of People with Disabilities	93.768	160,097
Health Insurance for the Aged - Supplementary Medical Insurance	93.774	5,635,441
Centers for Medicare and Medicaid Services (CMS) Research, Demonstrations, and Evaluations	93.779	906,634
Grants to States for Operation of Offices of Rural Health	93.913	345,502
HIV Care Formula Grants	93.917	120,742,366
Cooperative Agreements for State-Based Comprehensive Breast and Cervical Cancer Early Detection Program	93.919	55
Cooperative Agreements to Support Comprehensive School Health Programs to Prevent the Spread of HIV and Other Important Health Problems	93.938	631,911
HIV Prevention Activities - Health Department Based	93.940	17,085,512
HIV Demonstration, Research, Public and Professional Education Projects	93.941	1,839,422
Human Immunodeficiency Virus (HIV)/Acquired Immunodeficiency Virus Syndrome (AIDS) Surveillance	93.944	2,633,701
Assistance Program for Chronic Disease Prevention and Control	93.945	199,399

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Tuberculosis Demonstration, Research, Public and Professional Education	93.947	45,143
Improving EMS/Trauma Care in Rural Areas	93.952	37,277
Block Grants for Community Mental Health Services	93.958	56,996,921
Block Grants for Prevention and Treatment of Substance Abuse	93.959	255,928,610
Preventive Health Services - Sexually Transmitted Disease Control Grants	93.977	5,861,269
Preventive Health Services - Sexually Transmitted Diseases Research, Demonstrations, and Public Information and Education Grants	93.978	1,755,630
Health Program for Refugees	93.987	616,621
Cooperative Agreements for State-Based Diabetes Control Program and Evaluation of Surveillance Systems	93.988	619,525
Preventive Health and Health Services Block Grant	93.991	7,651,028
Maternal and Child Health Services Block Grant to the States	93.994	44,034,133
Other - Department of Health and Human Services	93.999	14,369,204
Total Excluding Clusters		7,119,794,265
Aging Cluster		
Special Programs for the Aging - Title III, Part B - Grants for Supportive Services and Senior Centers	93.044	38,624,934
Special Programs for the Aging - Title III, Part C - Nutrition Services	93.045	51,319,696
Nutrition Services Incentive Program	93.053	10,654,988
Total Aging Cluster		100,599,618
Child Care Cluster		
Child Care and Development Block Grant	93.575	811,383,586
Child Care Mandatory and Matching Funds of the Child Care and Development Fund	93.596	251,543,815
Total Child Care Cluster		1,062,927,401

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Medicaid Cluster		
State Medicaid Fraud Control Units	93.775	16,569,656
State Survey and Certification of Health Care Providers and Suppliers	93.777	32,478,900
Medical Assistance Program	93.778	18,497,303,273
Total Medicaid Cluster		18,546,351,829
Research and Development Cluster		
Maternal and Child Health Federal Consolidated Programs	93.110	180,906
Consolidated Knowledge Development and Application (KD&A) Program	93.230	72,909
Total Research and Development Cluster		253,815
Total U.S. Department of Health and Human Services		26,829,926,928
Corporation for National and Community Service		
State Commissions	94.003	1,311,714
Learn and Serve America - School and Community Based Programs	94.004	2,794,811
AmeriCorps	94.006	15,892,209
Total Excluding Clusters		19,998,734
Foster Grandparent/Senior Companion Cluster		
Foster Grandparent Program	94.011	1,517,382
Total U.S. Corporation for National and Community Service		21,516,116
Social Security Administration		
Disability Insurance/SSI Cluster		
Social Security - Disability Insurance	96.001	189,715,018

Federal Agency/Program Title	Federal Catalog Number	Grant Amount Received
Department of Homeland Security		
Homeland Security Grant Program	97.004	776,000
Urban Areas Security Initiative	97.008	6,014,473
Hazardous Materials Assistance Program	97.021	4,650
Crisis Counseling	97.032	901,095
Individual and Family Grants	97.035	150
Public Assistance Grants	97.036	284,903,158
Hazard Mitigation Grant	97.039	63,503,492
Emergency Management Performance Grants	97.042	91,938
Cooperating Technical Partners	97.045	1,376
Fire Management Assistance Grant	97.046	13,904,957
Total U.S. Department of Homeland Security		370,101,289
Office of National Drug Control Policy		
High Intensity Drug Trafficking Area	See Note 4	5,522,611
Miscellaneous Grants and Contracts		
Shared Revenue - Flood Control Lands	99.002	383,724
Shared Revenue - Grazing Land	99.004	111,445
U.S. Department of the Interior - Fire Prevention/ Suppression Agreement	99.014	134,000
U.S. Department of the Interior - Fire Prevention/ Suppression Agreement	99.015	252,310
U.S. Department of Agriculture and Various Other U.S. Department - Fire Prevention/Suppression	99.016	22,228,717
Miscellaneous Federal Receipts	99.099	523,880
Miscellaneous Federal Receipts	99.999	4,211,823
Total Miscellaneous		27,845,899
Total Federal Awards Received		$70,728,915,254

* Amount includes value of commodities or food stamps.

** Amount includes donated property.

*** Amount includes loans and insurance in effect as of June 30, 2004.

NOTES TO THE SCHEDULE OF FEDERAL ASSISTANCE
FISCAL YEAR ENDED JUNE 30, 2004

1. GENERAL

The accompanying State of California Schedule of Federal Assistance presents the total amount of federal financial assistance programs received by the State of California for the fiscal year ended June 30, 2004. This schedule does not include expenditures of federal grants received by the University of California, the California State University, and the California Housing Finance Agency. The expenditures of the University of California, California State University, and California Housing Finance Agency are audited by other independent auditors in accordance with the U.S. Office of Management and Budget, Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (OMB Circular A-133).

The $70,728,915,254 in total federal assistance consists of the following:

Cash assistance received	$45,801,335,207
Noncash federal awards	2,211,734,600
Loans and/or loan guarantees outstanding	22,664,934,194
Insurance in-force	50,911,253
Total	**$70,728,915,254**

2. BASIS OF ACCOUNTING

OMB Circular A-133 and the Single Audit Act of 1984 (Amended 1996) require the Schedule of Federal Assistance to present total expenditures for each federal assistance program. However, although the state accounting system separately identifies revenues for each federal assistance program, it does not separately identify expenditures for each program. As a result, the State prepares its Schedule of Federal Assistance on a cash receipts basis. The schedule shows the amount of cash and noncash federal assistance received, loans and loan guarantees outstanding, and insurance in force for the year ended June 30, 2004.

3. UNEMPLOYMENT INSURANCE

Of the $7,066,336,721 in total unemployment insurance funds (federal catalog number 17.225) received by the Employment Development Department during fiscal year 2003-04, $6,721,537,917 was state unemployment insurance funds that were drawn down from the Unemployment Trust Fund (UTF) in the U.S. Treasury. Of the amount drawn down from the UTF, $827,232,600 represented excess unemployment insurance funds spent in accordance with the Reed Act. Specifically, EDD used $78,793,999 for unemployment insurance administrative expenditures, $714,713,884 for unemployment insurance benefit payments, and $33,724,717 for employment services administrative expenditures.

4. OTHER

The California Department of Justice (DOJ) receives cash reimbursements from local law enforcement agencies under the Office of National Drug Control Policy's High Intensity Drug Trafficking Area program. During the period July 1, 2003 through June 30, 2004, the DOJ received the following cash reimbursements from pass-through entities:

Federal Agency/Program	Pass-through Entity	Grant Number	Amount
Office of National Drug Control Policy High Intensity Drug Trafficking Area			
	LA Police Chiefs Association	12PLAP534	$ 11,809
		13PLAP534	1,317,880
		14PLAP534	132,383
		13PSFP501	100,984
		11PNVP501	2,874
		12PNVP501	73,482
	California Border Alliance Group	11PSCP575	170,552
		12PSCP575	16,944
		13PSCP575	1,707,601
		14PSCP575	450,539
	Northwest High Intensity Drug Traffic Area	11PNWP505	46,500
	Las Vegas Police Department	11PNVP501	4,861
		12PNVP501	21,506
	Clallum County Sheriffs	200JCKWX0177	40,867
	Criminal Information Sharing Alliance	PCA1000310001	1,303,026
	Institute for Intergovernmental Research	2003RSCX1002	120,803
	Total		$5,522,611

The State was also loaned Federal Excess Personal Property (FEPP) from the U.S. Forest Service during the period July 1, 2003 to June 30, 2004. According to the California Department of Forestry and Fire Protection, the amount loaned from July 1, 2003 to June 30, 2004, was $2,702,903. The U.S. Forest Service and the State maintain the FEPP program at federal acquisition costs of the property.

Summary Schedule of Prior Audit Findings

Prepared by
Department of Finance

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS

Reference Number:	**2003-12-1**
Federal Program:	All Programs
State Administering Department:	Department of Finance
Fiscal Year Initially Reported:	1995-96
Audit Finding:	Reporting. Because of limitations in its automated accounting systems, the State has not complied with the provision of OMB Circular A-133 requiring a schedule showing total expenditures for each federal program.
Status of Corrective Action:	Remains uncorrected. The State's accounting system will require substantial modification to comply with federal and State requirements. Given the State's current limited resources, the Department of Finance has no plans at this time to enhance the State's accounting system or to implement a new system.[1]

Reference Number:	**2003-3-3**
Federal Program:	10.557
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Cash Management. Health Services does not always limit "prospective" payments of WIC program funds to the subrecipients' immediate needs. As a result, some subrecipients likely received WIC program funds in excess of their immediate cash needs.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2003-3-4**
Federal Program:	10.557
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Cash Management. During the first three quarters of state fiscal year 2002-03, Health Services used an incorrect method when transferring funds from the federal government. Although it corrected the error, using the modified zero balance accounting method during the fourth quarter, Health Services did not always apply this method correctly.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2003-3-6**
Federal Program:	10.568
State Administering Department:	Department of Social Services
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Cash Management. The Department of Social Services (Social Services) did not always limit cash advances of federal funds to the minimum amounts needed for the Emergency Food Assistance Program.
Status of Corrective Action:	Remains uncorrected/disagree with finding. Social Services re-evaluated its advance estimation process and believe it to be reasonable and consistent with Title 31, Part 205, Subpart B of the Code of Federal Regulations. The United States Department of Agriculture approved our revised process as sufficient corrective action in a May 10, 2004 letter.[2]

Reference Number:	**2003-9-4**
Federal Program:	10.568; 10.569
State Administering Department:	Department of Social Services
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Suspension and Debarment. For fiscal year 2002-03, the Department of Social Services (Social Services) did not require 46 of its Emergency Food Assistance Program subrecipients requiring suspension and debarment certifications to submit them.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2003-13-1**
Federal Program:	10.558
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Subrecipient Monitoring. The Department of Education (Education) did not adequately fulfill its subrecipient monitoring responsibilities for the food program.
Status of Corrective Action:	Fully corrected.[3]

Reference Number:	**2003-13-5**
Federal Program:	10.557
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Subrecipient Monitoring. The Department of Health Services (Health Services) did not perform required biennial reviews of subrecipients of WIC program funds.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2003-13-6**
Federal Program:	10.568; 10.569
State Administering Department:	Department of Social Services
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Subrecipient Monitoring. During fiscal year 2002-03, the Department of Social Services (Social Services) did not have an adequate system to ensure it met the OMB Circular A-133 requirements it must follow when it passes federal funds through to subrecipients.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2003-7-1**
Federal Program:	14.239
State Administering Department:	Department of Housing and Community Development
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Matching. The Department of Housing and Community Development's (Housing) system for determining whether it has made the necessary matching contributions for its HOME program is deficient.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2003-9-2**
Federal Program:	14.228
State Administering Department:	Department of Housing and Community Development
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Suspension and Debarment. The Department of Housing and Community Development (Housing) did not obtain the suspension and debarment certifications from 26 of 40 subrecipients of CDBG funds we reviewed.
Status of Corrective Action:	Fully corrected.

Reference Number: **2003-14-3**

Federal Program: 14.239

State Administering Department: Department of Housing and Community Development

Fiscal Year Initially Reported: 2002-03

Audit Finding: Special Tests and Provisions. Our review of six HOME contracts that had expenditures for rental housing developments in fiscal year 2002-03 revealed that Housing did not obtain the required layering analysis for one of them.

Status of Corrective Action: Fully corrected.

Reference Number: **2003-2-1**

Federal Program: Various

State Administering Department: Employment Development Department

Fiscal Year Initially Reported: 1998-99

Audit Finding: Allowable Costs. EDD allocated eight of 40 expenditures we reviewed even though it had not obtained federal approval to do so as part of its indirect cost rate proposal.

Status of Corrective Action: Partially corrected. Anticipated Correction Date: Ongoing.

1. The EDD will include documentation for its allocated costs in the indirect cost rate proposal.

2. The EDD reminds all staff periodically, and will do so again, that timesheets must be supervisor reviewed and approved.

Recent corrective Action:

- The EDD has convened a workgroup to ensure the upcoming Indirect Cost Rate Proposal (March 2005) includes proper documentation for allocated costs.

- In May 2004 and September 2004, the EDD sent email notices to all staff explaining "Employee Time Reporting Responsibilities."[4]

Reference Number:	**2003-2-2**
Federal Program:	17.207; 17.203
State Administering Department:	Employment Development Department
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Allowable Costs. The Employment Development Department (EDD) drew down federal funds under one program to pay the costs of another program.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2003-4-1**
Federal Program:	20.205
State Administering Department:	Department of Transportation
Fiscal Year Initially Reported:	2000-01
Audit Finding:	Davis-Bacon; Suspension and Debarment; Special Tests and Provisions. The California Department of Transportation (Caltrans) could not always locate its contract files or other documents to show that it complied with certain federal requirements for its highway construction projects.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2003-9-3**
Federal Program:	20.505
State Administering Department:	Department of Transportation
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Suspension and Debarment. Although the California Department of Transportation (Caltrans) states in its guidance to subrecipients of the planning grant that subrecipients must submit suspension and debarment

certifications, Caltrans did not always have suspension and debarment certifications from its subrecipients.

Status of Correction Action: Partially corrected. Anticipated Correction Date: Fiscal year 2004-05. Caltrans responded that this corrective action is the responsibility of the Division of Transportation Planning (DOTP), Office of Regional and Interagency Planning (ORIP). This response and corrective action plan contains the procedural steps, roles and responsibilities that will be undertaken by ORIP and the Regional Planning Branches in Caltrans (Department's) Districts. Where such activities or products have already been completed it is noted below.

The ORIP recently updated the Master Fund Transfer Agreements (MFTAs) for Consolidated Planning Grant (CPG) funds and Rural Planning Assistance (RPA) funds; these contracts are between Metropolitan Planning Organizations (MPOs) and Regional Transportation Planning Agencies (RTPAs) and the Department. These contracts now specifically include the Federal Highway Administration (FHWA) and Federal Transit Administration (FTA) Certifications and Assurances (C&As), including the Suspension and Debarment Certification.

- It is the intent that all the MFTAs be completed and executed during the current fiscal year 2004-05.

- The distribution of this transmittal and the OWP Guidance was completed in January 2004 and was provided to MPOs/RTPAs and the Department's Districts.

In past years, due to unmitigable circumstances, CPG discretionary grant fund approvals (FTA 5313 [b] and FHWA SP&R Partnership Planning) have been off cycle. This meant that grants were later amended into approved OWPs. Should off cycle approval occur in the future, the following procedures are in place:

- ORIP Plan and Grants Branch – Grant Award Letter should indicate that both FHWA and FTA C&As must be completed for <u>any</u> CPG discretionary funds. (FTA C&As will be done for any CPG discretionary funds, not by fund source or type. That is, both FTA Section 5313 (b) and FHWA SP&R Partnership Planning will require FTA C&As).

- Districts will not submit an OWP/OWPA amendment to encumber any discretionary grant funds without providing copies of both FHWA and FTA C&As.

- ORIP Plan and Grants Branch will revise its grant checklist (completed by the ORIP Regional Liaisons) to include the completed C&As.

- ORIP Regional Liaisons cannot provide the OWP/OWPA amendment to the ORIP Funds Administrator for encumbrance until both FHWA and FTA C&As are completed and on file.

- ORIP Funds Administrator will not encumber grants funds amended into the OWPs/OWPAs until the grant checklist is marked to show that both the FHWAs and FTA C&As are completed.

ORIP believes that placing a greater emphasis on the completion of C&As in the updated MFTA, annual OWP Guidance and implementing the above procedures will assure that all C&As, including the Suspension and Debarment Certification, are completed and appropriately retained. CPG funds for fiscal year 2004-05 and beyond will not be encumbered without both the FHWA and FTA proof of completion of both the FHWA and FTA Certifications.[5]

Reference Number:	**2003-12-4**
Federal Program:	66.458
State Administering Department:	State Water Resources Control Board
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Reporting. As a result of the accounting for EPA grant funding on a first in first out basis, the manner in which the Fund has been applying the indirect cost allocation on a monthly basis to the grant awards has resulted in incorrect reporting of the indirect cost rate on the Form 269s filed for each grant award. Although there were incorrect amounts reported, the Fund did not draw funds in excess of the amounts allowed and therefore there are no questioned costs.
Status of Corrective Action:	Fully corrected.

Reference Number: **2003-12-2**

Federal Program: 83.544; 83.548

State Administering Department: Office of Emergency Services

Fiscal Year Initially Reported: 1999-00

Audit Finding: Reporting. Emergency Services' financial status reports do not always contain complete and accurate expenditure information.

Status of Corrective Action: Remains uncorrected/agree with finding. OES has made several attempts over the years to discuss with the Federal Emergency Management Agency (FEMA) how best to report California disaster activity (which involves more than 23,000 individual projects) into a single generic format. Although OES has informally discussed the issue with FEMA staff, given the repeat nature of this finding, OES will initiate a formal request to FEMA management this year to reach a consensus on how to report on-going disaster assistance activity without creating a burdensome workload for the state.

While the above is valid, the individual grant programs under Public Assistance and Hazard Mitigation do have other procedures, including a quarterly report process, in place at the unit level to monitor disbursements and to aide staff in ensuring subrecipients comply with federal program regulations and administrative requirements.[6]

Reference Number: **2003-13-3**

Federal Program: 83.544; 83.548

State Administering Department: Office of Emergency Services

Fiscal Year Initially Reported: 2001-02

Audit Finding: Subrecipient Monitoring. The Office of Emergency Services (Emergency Services) did not adequately fulfill its subrecipient monitoring responsibilities for its Public Assistance Grants and Hazard Mitigation Grant programs.

Status of Corrective Action:	Remains uncorrected/agree with finding. During the past 12 months, OES has experienced a staffing decrease of approximately 40 percent, while at the same time experiencing an increased workload related to Homeland Security grants. OMB Circular A-133 subrecipient monitoring will be reinstated when staffing levels are increased to meet all of the programmatic requirements. Meanwhile, OES does have other programmatic procedures in place to ensure that subrecipients comply with federal program regulations and administrative requirements.[7]

Reference Number:	**2003-1-5**
Federal Program:	84.048
State Administering Department:	California Community Colleges, Chancellor's Office
Fiscal Year Initially Reported:	2002-03
Audit Finding:	<u>Activities Allowed</u>. The Chancellor's Office did not ensure that it approved applications for subrecipients of the Vocational Education program.
Status of Corrective Action:	Fully Corrected.

Reference Number:	**2003-3-1**
Federal Program:	84.027; 84.173
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2001-02
Audit Finding:	<u>Cash Management</u>. The Department of Education (Education) does not have adequate procedures to ensure that program subrecipients demonstrate the ability to minimize the elapsed time between their receipt and use of federal program funds.
Status of Corrective Action:	Fully corrected.[8]

Reference Number: **2003-3-5**

Federal Program: 84.048; 84.243

State Administering Department: California Community Colleges, Chancellor's Office

Fiscal Year Initially Reported: 1997-98

Audit Finding: Cash Management. The California Community Colleges, Chancellor's Office (Chancellor's Office) does not have adequate procedures to ensure that subrecipients of the Vocational Education - Basic Grants to States program (Vocational Education) and Tech-Prep Education program (Tech-Prep) minimize the time elapsing between their receipt and use of federal program funds.

Status of Corrective Action: Fully Corrected.[9]

Reference Number: **2003-3-7**

Federal Program: 84.010; 84.298

State Administering Department: Department of Education

Fiscal Year Initially Reported: 2001-02

Audit Finding: Cash Management. The Department of Education (Education) does not have adequate procedures to ensure that program subrecipients demonstrate the ability to minimize the time elapsing between their receipt and use of federal program funds.

Status of Corrective Action: Partially corrected. Education continues to allocate funds proportionate to the unpaid months that have elapsed prior to and including the month of the current apportionment, based on the principle that local education agencies (LEAs) incur federal expenditures fairly constant through the year. During the 2003-04 fiscal year, Education included language in apportionment letters to notify LEAs of a potential delay in funding if significant carry over balances existed. The next step will be a separate written notification to the non-compliant LEAs that will detail specific dollar amounts and percentages. Currently our plan is to issue this notification at the release of the 40 percent payment.

As a result of adding language to apportionment letters regarding the remittance of interest earned in excess of $100, LEAs have returned federal interest to Education. Education has returned to the federal government any interest earned over $100 received from the LEAs.

Regarding Title V, revisions are being made to Part II of the Consolidated Application to include collection of expenditure data. Education will evaluate this data in relation to cash management issues.

Regarding Title I, the program office monitors the percentage of carry over balances as submitted on Part I of the Consolidated Application. When an LEA is over their 15 percent carry over limit, a waiver is requested from the program office. Program staff reviews/approves and notifies fiscal staff if funds should be withheld.[10]

Reference Number:	**2003-3-8**
Federal Program:	84.318
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Cash Management. The Department of Education (Education) does not have adequate procedures to ensure that Education Technology State Grants program subrecipients demonstrate the ability to minimize the time elapsing between their receipt and use of federal program funds.
Status of Corrective Action:	Partially corrected. Education is exploring various methods for an optimal monitoring approach, including seeking guidance from the USDE to meet federal monitoring expectations with Education's limited resources. In the interim, Education continues to monitor end of period expenditure reports, which provides signed assurances that funds were expended in accordance with the grant award documents. In addition, the end of period expenditure reports include a reporting section that requires LEAs to indicate interest earned on advance payments, and to remit prompt payment of interest greater than $100.[11]

Reference Number: **2003-3-9**

Federal Program: 84.002

State Administering Department: Department of Education

Fiscal Year Initially Reported: 2002-03

Audit Finding: Cash Management. The Department of Education (Education) does not have adequate procedures to ensure that Adult Education subrecipients demonstrate the ability to minimize the time elapsing between their receipt and use of federal program funds.

Status of Corrective Action: Fully corrected.[12]

Reference Number: **2003-3-10**

Federal Program: 84.011

State Administering Department: Department of Education

Fiscal Year Initially Reported: 1999-00

Audit Finding: Cash Management. The Department of Education (Education) does not have adequate procedures to ensure that Migrant Education program subrecipients demonstrate the ability to minimize the time elapsing between their receipt and use of federal program funds.

Status of Corrective Action: Fully corrected.

Reference Number: **2003-3-11**

Federal Program: 84.365; 84.367

State Administering Department: Department of Education

Fiscal Year Initially Reported: 2002-03

Audit Finding: Cash Management. The Department of Education (Education) does not have adequate procedures to ensure that Title III - English Language Acquisition Grants and Improving Teacher Quality State Grants program subrecipients demonstrate the ability to minimize the time elapsing between their receipt and use of federal program funds.

Status of Corrective Action: Partially corrected. Education continues to assess a method to ensure minimal time elapses between the receipt and use of federal program funds. Title II and Title III program staff will use the balances from prior year financial reports to evaluate if future funds should be delayed. The apportionment of funds will be adjusted as needed. In addition, Title II funds continue to be apportioned in three payments during the last six months; February (40 percent), April (40 percent), and June (20 percent); and Title III funds will be disbursed in three payments throughout the year. Both disbursement approaches seem to be proportionate to the expenditure needs of the LEAs.[13]

Reference Number: **2003-5-1**

Federal Program: 84.126

State Administering Department: Department of Rehabilitation

Fiscal Year Initially Reported: 1996-97

Audit Finding: Eligibility. The Department of Rehabilitation (Rehabilitation) does not always determine applicant eligibility for the Vocational Rehabilitation program within the required time period.

Status of Corrective Action: Partially corrected. The Department of Rehabilitation's (Rehabilitation) ongoing efforts have resulted in a significant and steady decline in the number of overdue eligibility determinations.

Specifically, Rehabilitation will continue its ongoing corrective actions until satisfactory compliance is achieved, as follows:

Action #1 – Share information with district administrators
Action #2 – Inform and educate Rehabilitation staff
Action #3 – Local level monitoring of eligibility determinations
Action #4 – Executive level monitoring of eligibility determinations

These actions that were implemented in the Spring of 2003 resulted in a noticeable reduction in the percentage of overdue eligibility determinations for the

2002-03 reporting year (14.6 percent). Using BSA's methodology, Rehabilitation is pleased to report that preliminary review of raw data shows the overdue eligibility percentage for the July 1, 2003 to April 1, 2004 time frame is approximately 8 percent.[14]

Reference Number:	**2003-7-2**
Federal Program:	84.298
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Earmarking. The Department of Education (Education) does not have adequate procedures to ensure that it meets the Title V program earmarking requirements.
Status of Corrective Action:	Fully corrected.[15]

Reference Number:	**2003-7-3**
Federal Program:	84.048
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Level of Effort. The Department of Education (Education) did not ensure that it met its level of effort requirement for administration of the Vocational Education program for fiscal year 2002-03.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2003-9-1**
Federal Program:	84.126
State Administering Department:	Department of Rehabilitation
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Suspension and Debarment. The Department of Rehabilitation (Rehabilitation) did not obtain the required suspension and debarment certification from any of the five contractors we reviewed.

Status of Corrective Action:	Fully corrected.[16]

Reference Number:	**2003-12-3**
Federal Program:	84.048
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2000-01
Audit Finding:	Reporting. The Department of Education (Education) did not report accurate, complete, and supported data in its Vocational Education performance accountability report.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2003-13-7**
Federal Program:	84.048
State Administering Department:	California Community Colleges, Chancellor's Office
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Subrecipient Monitoring. The California Community Colleges, Chancellor's Office (Chancellor's Office) did not ensure that it issued management decisions within six months of receiving audit reports from its subrecipients and did not ensure that subrecipients took appropriate and timely corrective action on the audit findings.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2003-13-8**
Federal Program:	84.318
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Subrecipient Monitoring. The Department of Education (Education) does not sufficiently monitor the activities of its subrecipients awarded Education Technology State Grants program funds.

Status of Corrective Action:

Partially corrected. Education continues to develop and implement its monitoring process over Enhancing Education Through Technology (EETT) formula grant awards. In collaboration with the California Technology Assistance Project (CTAP), Education will implement the following actions:

- Developing procedures to utilize the CTAP[2] and technology hardware surveys to monitor the LEA's progress in implementing technology.

- Developing procedures to review the impact and accountability of EETT formula grant funds at the same time as the EETT competitive grant's annual site reviews are conducted.

- Developing procedures to conduct site visits to review the reasonableness of EETT formula expenditures and how they were spent in accordance with approved district technology plans.

- Requiring LEAs to submit a description of the process and accountability measures used to evaluate the extent to which activities funded under the program are effective in: (1) integrating technology into curricula and instruction; (2) increasing the ability of teachers to teach; and (3) enabling students to meet challenging State standards. A task force of CTAP and Education staff was formed to develop the process and procedures. Education developed the Education Technology Plan Benchmark Form that is required to be submitted when a tech plan is revised. The form requires the applicant to describe how it is meeting EETT Criteria 3.d. (Curriculum Component) and Criteria 4.b. (Professional Development Component Criteria), and will be used as a component of the random site review described in #3.

- Exploring the possibility of including a step to review LEAs awarded EETT formula grants in the Education Coordinated Compliance Review process.

- Developing procedures to review End of Period Expenditure Reports and signed Grant Award Assurances that were received from the LEAs in October 2004.

Reference Number: **2003-14-4**

Federal Program: 84.032

State Administering Department: California Student Aid Commission

Fiscal Year Initially Reported: 2002-03

Audit Finding: Special Tests and Provisions. During our review of four false certification claims that Student Aid paid to lenders and reimbursed with loan program funds, we noted that two of the four loans resulted in borrower refunds that occurred three years after Student Aid approved the borrowers' requests for a loan discharge.

Status of Corrective Action: Fully corrected.

Reference Number: **2003-14-6**

Federal Program: 84.011

State Administering Department: Department of Education

Fiscal Year Initially Reported: 2002-03

Audit Finding: Special Tests and Provisions. The Department of Education (Education) did not take into account all of the required information when it awarded subgrants to LEAs for the Migrant Education program.

Status of Corrective Action: Partially corrected. Education's 2004-05 Regional Application includes three sections that request information on the availability of funds from other federal, state, and local programs. One section is on the Staffing Profile, which requests the percentage of program positions funded from Migrant and other funding sources for regular and summer/intersession. Another section requests applicants to describe their process and procedures that LEAs may use to leverage other funds to provide services to migrant children. And the last section requests information to document the coordination and collaboration of the LEA.

Education is seeking clarification from USDE on how it should take into account the availability of funds from other federal, state, and local programs when determining the amount of subgrant it awards to LEAs.[17]

Reference Number:	**2003-14-7**
Federal Program:	84.032
State Administering Department:	California Student Aid Commission
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Special Tests and Provisions. Student Aid's auxiliary organization administers the loan program. However, the auxiliary organization has not developed adequate internal controls over its information systems to provide reasonable assurance that it keeps current, complete, and accurate records of each loan.
Status of Corrective Action:	Partially corrected. The following corrective actions have been implemented:

- The Commission and its auxiliary are currently in the process of reviewing bids from third-party vendors to perform a comprehensive security risk assessment.
- The Information Security Officer designation has been reassigned to the Director of Information Security and this position has been realigned to report directly to the EDFUND president.
- Access to the computer operations facility was removed for the one individual who did not have a legitimate need to perform her job duties.
- A procedural change was made in September 2003, to promptly remove system access for terminated employees.
- System access to both: (1) add, change, or delete information from student loan data, and (2) the information system's master files have been changed to provide for segregation of duties. Each authorized employee can perform only one, but not both, activities.

  The Commission continues to believe that a preventative control of the scope described may not be warranted. The following, however, will be undertaken during the federal fiscal year ending September 30, 2005, to address the concern:

  - Research and determine industry standards pertaining to such controls of similar organizations.

  - Evaluate the efficacy of implementing the controls recommended by the auditors, looking at the system capability, time and resources necessary to do so, as well as review any such options in light of the information gained from the industry standards research.

  - Internal Audit will periodically sample and review system activity on loans associated with auxiliary employees. Although not a preventative control, the results of Internal Audit's review will provide support for the decision as to whether additional preventative controls are necessary or cost effective.

- The auxiliary has established audit trails for table maintenance. During the federal fiscal year ending September 30, 2005, the auxiliary will examine the system's capability to produce reportable audit trails for data maintenance transactions.

- The Commission's operating agreement with the auxiliary organization has not been amended but was extended for one more year. The Commission believes that there are sufficient provisions in the Operating Agreement to appropriately enforce the auxiliary to maintain strong control over its information systems.[18]

Reference Number: **2003-14-8**

Federal Program: 84.032

State Administering Department: California Student Aid Commission

Fiscal Year Initially Reported: 2002-03

Audit Finding: Special Tests and Provisions. Student Aid's auxiliary organization annually reviews collection cost and recovery data to calculate the collection cost rate it will apply to borrowers' payments for the upcoming year. However, our review of the auxiliary's collection cost

	calculation revealed that the auxiliary factored in and recovered costs that were unallowable.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2003-14-9**
Federal Program:	84.010; 84.011
State Administering Department:	Department of Education
Fiscal Year Initially Reported:	1998-99
Audit Finding:	Special Tests and Provisions, Subrecipient Monitoring. The Department of Education (Education) did not require LEAs receiving Migrant Education funds to file with Education a specific written assurance that they have developed procedures and maintain records to comply with the comparability requirements. In addition, Education has not monitored whether LEAs receiving Migrant Education and Title I, Part A funds have complied with the requirement to provide school services that are at least comparable to services provided by schools not receiving these federal funds.
Status of Corrective Action:	Partially corrected. *Response with regards to Title I, Part C – Migrant Education:*

Education revised its fiscal year 2003-04 legal assurances for the Migrant Education program to state:

> The LEA has developed procedures for complying with comparability requirements and must maintain records that are updated biennially documenting compliance with those requirements. 20 U.S.C. Section 6321(c).

Education is seeking guidance from USDE on how to monitor comparability at the regional and district level. Once guidance is obtained, Education will revise its Migrant Fiscal Review Procedures to include steps to monitor comparability at the regional and district level. Education will also revise the fiscal review instrument to specifically include comparability requirements.

Furthermore, Education is working on utilizing information in the California Basic Educational Data System (CBEDS) to calculate comparability for Title I, Part C. CBEDS data includes grade span, enrollment, teacher-pupil ratio and the number of fulltime equivalent staff, which can be used to calculate teacher-student ratios at both Title I and non-Title I schools. However, the process for Title I, Part C is more complicated because an outside vendor manages the Migrant Education Program database. Education is exploring the possibility of merging the data from CBEDS and the Migrant Education Program database in order to calculate comparability for Title I, Part C by September 2005.

Response with regards to Title I, Part A:

Starting with the 2003-04 school year, Education began calculating comparability using CBEDS information.

Furthermore, Education is developing its monitoring protocol for site visits and will pilot test it in the 2005-06 school year. The new monitoring protocol embeds the assurances of Consolidated Application, Part I.[19]

Reference Number:	**2003-1-1**
Federal Program:	93.959
State Administering Department:	Department of Alcohol and Drug Programs
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Activities Allowed. The Department of Alcohol and Drug Programs (DADP) expended funds from its Block Grants for Prevention and Treatment of Substance Abuse program for unallowable activities.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2003-1-2**
Federal Program:	93.778
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Activities Allowed. During fiscal year 2002-03, the Department of Health Services (Health Services) did not always correctly reimburse vendors of Medicaid-

	covered drugs, resulting in Health Services underpaying some vendors.
Status of Corrective Action:	Partially corrected. The pricing issue affected four nutritional NDCs and was corrected as of August 14, 2004. The affected claims are currently in the Erroneous Paid Claim Process for reprocessing. Due to workload, the reprocessing of these claims has not yet been completed.

Reference Number:	**2003-1-3**
Federal Program:	93.778
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2001-02
Audit Finding:	Activities Allowed. The Department of Health Services (Health Services) did not always ensure that all services approved for Medicaid beneficiaries were supported by sufficient documentation.
Status of Corrective Action:	Fully corrected.[20]

Reference Number:	**2003-1-4**
Federal Program:	93.778
Fiscal Year Initially Reported:	2001-02
State Administering Department:	Department of Health Services
Audit Finding:	Activities Allowed. During fiscal year 2002-03, Health Services did not recover overpayments of Medicaid funds paid to health plans as capitation payments for beneficiaries who had died and thus were no longer eligible for Medicaid.
Status of Corrective Action:	Partially corrected. MMCD has implemented procedures effective April 2004 to automatically disenroll deceased beneficiaries beginning with the month after the beneficiaries' month of death. This prospectively eliminates the problem of managed care plans (MCP) receiving capitation for deceased beneficiaries after the month of death.

The DHS Office of Legal Services (OLS) is currently reviewing existing MCP contract language and statutory authority to determine Health Services' potential for exposure to lawsuits should MMCD attempt to retroactively recoup overpayments made to MCPs for deceased beneficiaries. Although MMCD will continue to work with OLS on this issue, OLS' preliminary position indicates Health Services has significant exposure.[21]

Reference Number:	**2003-3-2**
Federal Program:	93.044; 93.045
State Administering Department:	Department of Aging
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Cash Management. The Department of Aging (Aging) did not follow its procedures to ensure that subrecipients of the aging programs minimize the time elapsing between their receipt and use of federal program funds.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2003-3-12**
Federal Program:	93.568; 93.569
State Administering Department:	Department of Community Services and Development
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Cash Management. The Department of Community Services and Development (Community Services) does not have adequate procedures to ensure that it limits cash advances of federal program funds to the minimum amounts needed.
Status of Corrective Action:	Fully corrected.

Reference Number:	**2003-8-1**
Federal Program:	93.959
State Administering Department:	Department of Alcohol and Drug Programs
Fiscal Year Initially Reported:	2000-01
Audit Finding:	Period of Availability. The Department of Alcohol and Drug Programs (DADP) lacks adequate procedures to ensure that federal grant awards are obligated and spent within their applicable periods of availability for the Block Grants for Prevention and Treatment of Substance Abuse. In addition, it has not completed its corrective action on a period-of-availability finding we reported last year.
Status of Corrective Action:	Fully corrected. Partially corrected. The six transactions identified in the finding, totaling $38,197, were corrected and charged to an award that was available during the period the services were provided. The changes were completed December 31, 2003. DADP implemented edits in its accounting system that will reject any transaction recorded after the period of availability. The edits were completed August 12, 2003. Mandatory training for all DADP staff responsible for monitoring contracts was conducted on March 22 and April 7, 2004. The training included clear direction on the period of availability for federal grant expenditures and obligations. DADP completed its corrective action related to the Fiscal Year 2001-02 audit. Specifically, for the fiscal years involved, DADP exceeded its maintenance of effort (MOE) requirement under the Substance Abuse Prevention and Treatment Block Grant. The issue was resolved by substituting the excess MOE against the $145,491. DADP submitted revised MOE tables to the federal agency February 19, 2004. Desk procedure manuals that will include instruction on period availability for federal grants are still being prepared for the Accounting Office staff positions that process encumbrances and payables. DADP anticipates that the desk manuals will be completed by January 2005.

Reference Number:	**2003-9-5**
Federal Program:	93.558; 93.658
State Administering Department:	Department of Social Services
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Suspension and Debarment. The Department of Social Services (Social Services) did not obtain the required suspension and debarment certifications from two of the eight contractors we reviewed.
Status of Corrective Action:	Partially corrected. Anticipated Correction Date: June 30, 2005. The Corrective Action Plan has been implemented with the exception of the desk procedures. The signed certifications now accompany the contracts being forwarded for signature and execution. The "Contract Checklist" is currently being used and provides the Internet address as an alternative to the signed certifications to verify contractor status. The desk procedures are in the developmental stage and completion is anticipated by the end of the current state fiscal year.

Reference Number:	**2003-13-2**
Federal Program:	93.044; 93.045
State Administering Department:	Department of Aging
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Subrecipient Monitoring. The Department of Aging (Aging) is not fulfilling all of its monitoring responsibilities for the Area Agencies on Aging (area agencies).
Status of Corrective Action:	Partially corrected. Based on the limited resources, the AAA-Based Terms did not conduct any monitoring visits in fiscal year 2003-04. In calendar year 2003, six visits were conducted and in calendar year 2004, three visits were scheduled to be conducted, but one to PSA 16 had to be canceled due to weather. In response to diminished State resources, the Department of Aging has established a Monitoring Protocol Team to ensure that monitoring is performed

as efficiently as possible and in compliance with laws and regulations. The Monitoring Team oversees all logistical operations, writing of the report, and follow-up to ensure all documents are sent or received by the appropriate dates assigned.

The first monitoring visit under the new structure was conducted in August at PSA 14, Fresno Madera AAA. New tools were tested and the team provided a formal exit letter containing findings and recommendations for action to correct any deficiencies uncovered during the visit. The final monitoring report is due within 90 days from the visit and will follow a new streamlined format that includes an Executive Summary, Best Practices, Technical Assistance Recommendations, and a Corrective Action Plan. Best Practices are being placed on the web for use by all AAAs. Future visits will be guided by both the "risk assessment" process which will be in place and fully developed by the end of this fiscal year, and based upon available resources.[22]

Reference Number:	**2003-13-4**
Federal Program:	93.917
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Subrecipient Monitoring. Health Services does not adequately monitor subrecipients of the HIV Care Formula Grants program.

Status of Corrective Action:

- Case Management Program (CMP): Fully corrected.

- Consortia Program (CP): Partially corrected. The seven projects cited are scheduled for completion by March 31, 2005. As previously stated in Office of AIDS's (OA) original response to this finding, OA Care Section, which administers the CP, has administratively established a policy for fully monitoring each program contractor no less than once per three-year period. March 31, 2005 is the ending date of the three-year cycle.

- AIDS Drug Assitance Program (ADAP): Partially corrected. Twelve of the sixteen sites identified as having received annual funding during each of the last five years have been visited. The remaining sites will be visited by March 31, 2005.

Of the 50 site reviews required for fiscal year 2002-03, 45 have been performed. The remaining 5 site reviews will be completed by March 31, 2005.

ADAP continues to regularly evaluate results of site visits and reprioritizes sites to be visited based on volume and date last visited. Sites required to provide and implement a corrective action plan are also re-evaluated to ensure findings were corrected. As previously stated in OA's original response to this finding, the frequency of these visits continues to be impacted by state budget constraints that result in increased demands on staff's in-office time.

- Inadequate follow-up:

  - Saint Mary's Medical: Fully corrected. In March 2004, OA contacted Department of Health Services, Audits and Investigations, and discussed the findings regarding this contract's A-133 audit. A corrective action letter was sent to the contractor on March 22, 2004, instructing the contractor to submit a corrective action plan to OA within 30 days. OA's September 2004 site visit found full compliance with this finding.

  - California Pacific Medical Center: Anticipated Correction Date: January 2005. OA's site visit is scheduled for January 2005.[23]

Reference Number: **2003-13-9**

Federal Program: 93.568; 93.569

State Administering Department: Department of Community Services and Development

Fiscal Year Initially Reported: 2002-03

Audit Finding: Subrecipient Monitoring. The Department of Community Services and Development (Community Services) did not always review subrecipients' OMB Circular A-133 audit reports in time to issue any necessary management decisions within the required six-month period.

Status of Corrective Action: Fully corrected.[24]

Reference Number: **2003-14-1**

Federal Program: 93.959

State Administering Department: Department of Alcohol and Drug Programs

Fiscal Year Initially Reported: 2002-03

Audit Finding: Special Tests and Provisions. The Department of Alcohol and Drug Programs (DADP) did not ensure that independent peer reviews were conducted for at least 5 percent of the treatment providers receiving Block Grants for Prevention and Treatment for Substance Abuse funds.

Status of Corrective Action: Fully corrected.[25]

Reference Number: **2003-14-2**

Federal Program: 93.778

State Administering Department: Department of Health Services

Fiscal Year Initially Reported: 1997-98

Audit Finding: Special Tests and Provisions. As we discussed in our December 2003 report titled *Department of Health Services: It Needs to Better Plan and Coordinate Its Medi-Cal Antifraud Activities* (Report 2003-112), the Department of Health Services (Health Services) does not always ensure the continuing eligibility of enrolled providers.

Status of Corrective Action: Develop Re-enrollment Plan: Partially corrected. The Provider Enrollment Branch (PEB) recently prepared a comprehensive Draft Re-enrollment Work Plan that proposes to change existing procedures to more efficiently process re-enrollment applications. While the review of all re-enrollment applications would still be thorough, Health Services recognizes the need to utilize data driven targets which focus on identified fraud (consistent with the Malcolm Sparrow anti-fraud model). To that end, PEB continues to work closely with Audits and Investigations to identify those providers which post the greatest fraud risk, and will continue to conduct a comprehensive re-enrollment review of the provider. Providers deemed to pose little to no fraud risk will be subjected to a more streamlined review, ensuring that they continue to meet the standards of participation. Internal checklists and procedures have been completed and implemented.

Enforce Deactivation Laws: Fully corrected.

Establish Agreements with State Professional Licensing Boards: Partially corrected. Assembly Bill 3023 – Chapter 351, approved by the Governor, August 27, 2004, which adds Section 683(a) and (b) to the Business and Professions Code. The bill requires the Dental Board of California, the Medical Board of California, the Board of Psychology, the State Board of Optometry, the California State Board of Pharmacy, the Osteopathic Medical Board of California, and the State Board of Chiropractic Examiners to report to the Department of Health Services, within 10 working days, the name and license number of a person whose license has been revoked, suspended, surrendered, made inactive by the licensee, or placed in another category that prohibits the licensee from practicing his or her profession. The purpose of the reporting requirement is to prevent reimbursement by the state for Medi-Cal and Denti-Cal services provided after the cancellation of a provider's professional license. The enactment of AB 3023 enables Health Services to receive any changes in license status for prompt updating of the Provider Master File to ensure that only claims for Medi-Cal reimbursement are issued to eligible providers. Some Boards (Medical and Dental) currently provide information on suspended providers, but not within 10 days. The Department will work with the various boards to ensure the mandated information is received on a timely basis.[26]

Reference Number:	**2003-14-5**
Federal Program:	93.775; 93.778
State Administering Department:	Department of Health Services
Fiscal Year Initially Reported:	2002-03
Audit Finding:	Special Tests and Provisions. As we discussed in our December 2003 report titled *Department of Health Services:*

	It Needs to Better Plan and Coordinate Its Medi-Cal Antifraud Activities (Report 2003-112), the Department of Health Services (Health Services) does not always make timely or complete referrals to the Department of Justice (Justice).
Status of Corrective Action:	Fully corrected.

ENDNOTES—AUDITOR COMMENTS

[1] The status of this issue remains unchanged. Please refer to reference number 2004-12-1 for additional information.

[2] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-3-12 for additional information.

[3] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-13-2 for additional information.

[4] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-2-1 for additional information.

[5] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-9-3 for additional information.

[6] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-12-4 for additional information.

[7] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-13-9 for additional information.

[8] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-3-5 for additional information.

[9] We reported a similar weakness in our audit of fiscal year 2003-04 for the Tech-Prep Education program only. Please refer to reference number 2004-3-4 for additional information.

[10] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference numbers 2004-3-3 and 2004-3-9 for additional information.

[11] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-3-6 for additional information.

[12] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-3-2 for additional information.

[13] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference numbers 2004-3-7 and 2004-3-8 for additional information.

[14] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-5-1 for additional information.

[15] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-7-1 for additional information.

[16] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-9-4 for additional information.

[17] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-14-4 for additional information.

[18] Although less severe, we reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-14-3 for additional information.

[19] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-13-4 for additional information.

[20] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-1-5 for additional information.

[21] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-1-6 for additional information.

[22] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-13-6 for additional information.

[23] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-13-14 for additional information.

[24] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-13-11 for additional information.

[25] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-14-2 for additional information.

[26] We reported a similar weakness in our audit of fiscal year 2003-04. Please refer to reference number 2004-14-5 for additional information.

Department of Finance
State Capitol, Room 1145
Sacramento, CA 95814

March 15, 2005

Ms. Elaine M. Howle, State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Dear Ms. Howle:

State of California: Internal Control and State and Federal Compliance Audit Report for the Fiscal Year Ended June 30, 2004

Thank you for the opportunity to respond to the internal control and state and federal compliance audit report. This report was the result of your examination of the state's general purpose financial statements and administration of federal programs for the fiscal year ended June 30, 2004, and will be part of the Single Audit Report covering this period. We accept the reported findings and recommendations. Although our internal controls and administration of federal awards can always be improved, the state is committed to sound and effective fiscal oversight.

California provides its citizens with numerous state and federal programs and activities and is much more complex and vast than most economic entities in the world. Such complexity, along with ever-present budget constraints, challenges us to meet the requirements of those programs and activities efficiently and effectively. Moreover, such operations must exist within a system of internal and administrative control that safeguards assets and resources and produces reliable financial information. Attaining these objectives and overseeing the financial and business practices of the state continues to be an important part of the Department of Finance's leadership.

In meeting our responsibility for financial leadership and oversight, the Department of Finance conducts internal control reviews of state departments and also reviews areas of potential weakness in the state's fiscal systems. In addition, we provide oversight of departmental internal audit units by issuing audit guidelines and conducting quality assurance reviews. Further, we have an ongoing process of issuing audit memos to departments that establish statewide policy and provide technical advice on various audit related issues. We will soon issue an audit memo concerning the results of the fiscal year 2003-04 Single Audit.

The head of each state department is responsible for establishing and maintaining a system of internal accounting and administrative control within their department. This responsibility includes documenting the system, communicating system requirements to employees, and assuring that the system is functioning as prescribed and is modified for changing conditions.

Moreover, all levels of state management must be involved in assessing and strengthening their system of internal accounting and administrative controls to minimize fraud, errors, abuse, and waste of government funds.

Individual departments have separately responded to the report's findings and recommendations. Accordingly, their viewpoints and corrective action plans are included in the report. We will monitor the findings and reported corrective actions to identify potential changes in statewide fiscal procedures. Specifically, in regards to the disclaimer for the Crime Victim Assistance, we continue to monitor the Office of Emergency Services' progress in implementing their corrective action plan.

The Department of Finance will continue to provide leadership to ensure the proper financial operations and business practices of the state, and to ensure that internal controls exist for the safeguarding and effective use of assets and resources.

If you have any questions concerning this letter, please contact Samuel E. Hull, Chief, Office of State Audits and Evaluations, at (916) 322-2985.

Sincerely,

(Original Signed By: Stephen W. Kessler)

STEPHEN W. KESSLER
Chief Deputy Director